Supreme Court, U.S.
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No.

In the

Supreme Court of the United States

ERNST & YOUNG LLP, et al.,

Petitioners,

v.

SHARON P. CLARK,
Commissioner for the Kentucky Department of Insurance and Rehabilitator of AIK Comp, et al.,

Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Kentucky

PETITION FOR WRIT OF CERTIORARI

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November 22, 2010

QUESTION PRESENTED

Whether the Federal Arbitration Act, 9 U.S.C. § 2, is "reverse preempted" by the McCarran-Ferguson Act, 15 U.S.C. § 1012(b), such that state law vitiates an arbitration agreement covering an ordinary tort suit between the rehabilitator of an insolvent insurer and an auditor?

PARTIES TO THE PROCEEDING

Petitioners in this Court, defendants-appellants below, are Ernst & Young LLP and David S. Meyer. Respondents in this Court, plaintiffs-appellees below, are Sharon P. Clark, in her official capacity as Commissioner for the Kentucky Department of Insurance and Rehabilitator of AIK Comp; Stephen P. Lattanzio; Actuarial & Technical Solutions, Inc.; and John and Jane Does, all unknown actuaries and accountants.

Appalachian Regional Healthcare, Inc.; Apollo Oil, LLP; Art's Electric, Inc.; Crittenden Health Systems; European Design, Inc.; Fischer Special Manufacturing Co.; Gallatin Health Care, LLC; Hopewell Farm, LLC; Louden & Co., LLC; M & M Cartage, Inc.; Modco Transport; and Pattie A. Clay Regional Medical Center were parties to a separate suit, which was consolidated in the Kentucky Supreme Court proceedings below. Petitioners do not seek this Court's review of the judgment in that case.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioner Ernst & Young LLP states that it has no parent corporation and that no publicly held corporation owns 10% or more of Ernst & Young LLP.

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OPINIONS BELOW

The opinion of the Supreme Court of Kentucky is reported at ___ S.W.3d ___, 2010 WL 3374414, and is reproduced in the appendix at App. 1.

The unpublished order of the Kentucky Supreme Court transferring the case from the Kentucky Court of Appeals is reproduced at App. 27.

The unpublished opinion and order of the Franklin Circuit Court, which was affirmed by the Kentucky Supreme Court, is reproduced at App. 29.

JURISDICTION

The Kentucky Supreme Court rendered its decision on August 26, 2010, affirming the denial of Petitioners' motion to compel arbitration. This petition for certiorari was filed within 90 days, on November 22, 2010. This Court has jurisdiction under 28 U.S.C. § 1257(a). *Southland Corp. v. Keating*, 465 U.S. 1, 6–8 (1984).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Section 2(b) of the McCarran-Ferguson Act, 15 U.S.C. § 1012(b), provides in pertinent part:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.

Section 2 of the Federal Arbitration Act, 9 U.S.C. § 2, provides in pertinent part:

> A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Ky. Rev. Stat. Ann. § 304.33-010(6) provides:

> If there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle.

Ky. Rev. Stat. Ann. § 304.33-040(3)(a) provides:

> The court shall have exclusive jurisdiction to entertain, hear, or determine all matters in any way relating to any delinquency proceeding under this subtitle, including, but not limited to, all disputes involving purported assets of the insurer.

U.S. Const., Art. VI, cl. 2, is reproduced in the Appendix at App. 41. Ky. Rev. Stat. Ann. §§ 304.033-010, -030, -040, -140, and -160 are reproduced in full starting at App. 42.

STATEMENT OF THE CASE

This case involves an effort by the Kentucky Supreme Court to protect the State's anti-arbitration policies from federal preemption by giving an extraordinarily broad construction to the McCarran-Ferguson Act, 15 U.S.C. § 1012(b). That Act protects state laws that are enacted "for the purpose of regulating the business of insurance" from being "invalidate[d], impair[ed], or supersede[d]" by general federal laws, such as the Federal Arbitration Act ("FAA"), 9 U.S.C. § 2. The decision below extends the McCarran-Ferguson Act far beyond the limits carefully imposed by this Court and vitiates the critical federal policy underlying the FAA in the context of an ordinary tort suit far removed from the business of insurance.

The decision below read an exclusive-jurisdiction provision to reflect an anti-arbitration policy, and then it construed the McCarran-Ferguson Act to allow Kentucky to prohibit arbitration of a garden-variety tort suit brought on behalf of an insolvent insurer against its former auditor. The question of whether that dispute should be arbitrated has virtually nothing to do with the "business of insurance" — indeed, the underlying dispute itself has no apparent connection to the core "business of insurance," *i.e.*, spreading of risk from insured to insurer. Kentucky's anti-arbitration policy is not limited to disputes between policyholders and the insurer, or even between an insurer and a reinsurer. Instead, the Kentucky Supreme Court extended that policy to "all matters in any way relating to any [insurer] delinquency proceedings," including arbitration of disputes like this between an insurer and third-party

auditors or suppliers sounding in ordinary tort and contract principles. Ky. Rev. Stat. Ann. § 304.33-040(3)(a). Notwithstanding this "extremely broad" anti-arbitration rule and the lack of any meaningful connection between it and policyholders, the Kentucky Supreme Court held that the McCarran-Ferguson Act applied and reverse preempted the FAA as to arbitration of this dispute over alleged auditing negligence. App. 14, 19–20.

That decision cannot be reconciled with this Court's precedents, especially *Department of Treasury v. Fabe*, 508 U.S. 491 (1993). The Kentucky Supreme Court's conclusion is also contrary to that of the United States Court of Appeals for the Sixth Circuit, when faced with a similar fact pattern, reflecting deeper tension among the Courts of Appeals as to the scope of protection for forum-preference provisions in similar state liquidation laws. To cabin the McCarran-Ferguson Act to its proper bounds, to reaffirm this Court's precedents, to vindicate the important policies of the FAA, and to clarify this confusion among the lower courts, this Court should grant review.

A. Factual Background

1. Petitioner Ernst & Young LLP ("Ernst & Young") is a firm that provides accounting, auditing, and other services. Petitioner David S. Meyer is an Ernst & Young partner. Respondent, the Commissioner for the Kentucky Department of Insurance, was appointed pursuant to Kentucky's Insurers Rehabilitation and Liquidation Law ("Liquidation Law" or "IRLL"), Ky. Rev. Stat. Ann. § 304.33-010 et seq., as Rehabilitator for AIK Comp

("AIK"). App. 3, 6. AIK is a Kentucky workers' compensation self-insured group. *Id.* Under Kentucky law, workers' compensation through a self-insurance group is similar to ordinary workers' compensation insurance, except that if the group is unable to meet its obligations, the participants are jointly and severally liable for the shortfall. *Assoc. Indus. of Ky., Inc. v. U.S. Liability Ins. Group*, 531 F.3d 462, 464 (6th Cir. 2008).

From 1999 through 2003, Ernst & Young entered into a series of contracts with AIK for auditing and accounting services. App. 4. Each of those contracts includes a mandatory arbitration clause. Although the agreements varied over time, the pertinent portion remained unchanged: "Any controversy or claim arising out of or relating to" Ernst & Young's services "shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitration. . . ." App. 4–5. The parties also agreed that arbitration would be governed by the FAA. *Id.*

Ernst & Young audited AIK's financial statements annually until 2002. App. 5. Each of Ernst & Young's audits indicated that AIK's assets exceeded its liabilities. App 6. In 2003, Ernst & Young resigned as AIK's auditor. App. 5–6.

2. In April 2004, the Kentucky Office of Workers' Claims initiated a financial examination of AIK. App. 6; Ernst & Young Br. 3. That examination revealed that AIK was unable to pay insurance claims because it faced a deficit. App. 6. That deficit grew to approximately $90 million. *Id.* AIK was placed in "rehabilitation" and a "Rehabilitator" was appointed.

Id.; *see* Ky. Rev. Stat. Ann. §§ 304.33-040, -140, -150. The Rehabilitator has required AIK members to pay assessments to cover most of the shortfall. App. 6–7.

The Rehabilitator sued Ernst & Young in Kentucky's Franklin Circuit Court, raising various tort theories of liability. App. 7. The Rehabilitator's claims are brought "on behalf of [AIK]" and are entirely derivative of "causes of action that [AIK] could have maintained in its own name." Compl. ¶¶ 11–12. The Rehabilitator alleges that Ernst & Young negligently audited AIK's financial statements in that those statements materially underestimated the losses AIK would incur due to future claims and, as a result, AIK charged its members premiums that were too low. Compl. ¶¶ 23–25, 42–45. The Rehabilitator sought as damages rehabilitation costs it allegedly would have avoided if it had rehabilitated AIK sooner rather than later. *Id.* ¶ 31. The Rehabilitator sought to resist Ernst & Young's effort to compel arbitration on the basis of a Kentucky law giving a Kentucky court exclusive jurisdiction over "matters relating to any delinquency proceeding." App. 12–13. The threshold question thus arose whether the arbitration clauses in Ernst & Young's contracts are enforceable in the Rehabilitator's tort suit.

B. Statutory Framework

1. The FAA establishes a "national policy favoring arbitration when the parties contract for that mode of dispute resolution." *Preston v. Ferrer*, 552 U.S. 346, 349 (2008). "The FAA's displacement of conflicting state law is 'now well-established'" and has been "repeatedly reaffirmed." *Id.* at 353 (quoting *Allied-*

Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 272 (1995)).

2. Two provisions of Kentucky's Liquidation Law have been construed to prohibit arbitration broadly when an insurer becomes insolvent and enters delinquency proceedings. Section 304.33-040(3)(a) ("Section 40") grants Kentucky courts "exclusive jurisdiction" over "all matters in any way relating to any delinquency proceeding." And § 304.33-010(6) ("Section 10") provides that, if there is a delinquency proceeding, "all conflicting contractual provisions contained in any contract between the insurer . . . and any third party shall be deemed subordinated" to the Liquidation Law.

Ordinarily, an arbitration clause does not conflict with a grant of exclusive jurisdiction because arbitration does not forgo "substantive rights afforded by [a] statute; it only submits to their resolution in an arbitral, rather than a judicial forum." *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 229–30 (1987) (quotation marks omitted). If there is nonetheless a conflict because a state law granting exclusive jurisdiction is construed to prohibit arbitration, however, ordinary preemption principles would require arbitration pursuant to the FAA. App. 10–11; *see Preston*, 552 U.S. at 353. The single, dispositive question here is whether the McCarran-Ferguson Act requires a different result.

3. The McCarran-Ferguson Act provides that, unless a federal law "specifically relates to the business of insurance," it shall not be construed to "invalidate, impair, or supersede" any state law "enacted . . . for the purpose of regulating the business

of insurance." 15 U.S.C. § 1012(b). Accordingly, "when Congress enacts a law specifically relating to the business of insurance, that law controls." *Humana, Inc. v. Forsyth*, 525 U.S. 299, 306 (1999). But when Congress enacts legislation that is "general in character," that law "shall not be 'construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance.'" *Id.* at 306–07. There is no dispute that the FAA is such a general law. When the McCarran-Ferguson Act blocks the preemptive impact of a general federal law, such as the FAA, it is known as "reverse preemption." *E.g.*, *AmSouth Bank v. Dale*, 386 F.3d 763, 782 (6th Cir. 2004).

A state law falls within the scope of the McCarran-Ferguson Act's protection if it "possess[es] the end, intention, or aim of adjusting, managing, or controlling" the "business of insurance." *Fabe*, 508 U.S. at 505 (quotation marks omitted). The Act's protections are not absolute, however. "When federal law does not directly conflict with state regulation, and when application of the federal law would not frustrate any declared state policy or interfere with a State's administrative regime, the McCarran-Ferguson Act does not preclude its application." *Humana*, 525 U.S. at 310.

The Court has made clear that a state law is not considered as a whole when assessing whether it "regulat[es] the business of insurance" or is frustrated by a general federal policy. Instead, the question is whether the application of a particular section or subsection of the law triggers reverse preemption. In *Fabe*, for example, the Court concluded that a state statute setting creditor priority in insurer liquidation

proceedings had reverse-preemptive effect to the extent it gave priorities to policyholders, but not to the extent it gave priority to ordinary third-party creditors. *Fabe*, 508 U.S. at 493–94.

The Court has also emphasized that the focus of the Act is on "the relationship between the insurance company and the policyholder" — and at its core lies the transfer of risk from insured to insurer. *Id.* at 501 (quoting *SEC v. Nat'l Securities, Inc.*, 393 U.S. 453, 460 (1969)). This Court has used three factors to determine whether a practice falls within the "business of insurance": whether it (1) "has the effect of transferring or spreading a policyholder's risk"; (2) "is an integral part of the policy relationship between the insurer and the insured"; and (3) "is limited to entities within the insurance industry." *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129 (1982). Conversely, a state law is *not* protected from preemption by a general federal law if the state law does not "possess the 'end, intention, or aim' of adjusting, managing, or controlling" (1) the transfer of risk; (2) another "integral part of the policy relationship between the insurer and the insured"; or (3) a practice that is limited to the insurance industry. *Fabe*, 508 U.S. at 505; *Pireno*, 458 U.S. at 129.

C. Procedural History

1. On March 25, 2005, the Rehabilitator sued Ernst & Young in Franklin Circuit Court. Members of AIK that paid assessments to cover AIK's shortfalls subsequently brought a class action against Ernst & Young. App. 7.

Ernst & Young moved to compel arbitration in both suits, arguing that the FAA mandated their

enforcement and that the McCarran-Ferguson Act did not reverse preempt the FAA. *Id.* As Ernst & Young's counsel put it, "McCarran-Ferguson does not keep . . . the FAA from applying" because "a garden variety, run-of-the-mill claim against Ernst & Young has nothing to do with the regulation or taxation of the business of insurance." Hearing Tr. at 50, Franklin Cir. Ct. (Aug. 28, 2007).

The Franklin Circuit Court denied the motions to compel in both cases. App. 7. Among other reasons for denying the motion in the Rehabilitator's suit, the court held that the McCarran-Ferguson Act reverse preempted the FAA. App. 38–39.

2. Ernst & Young appealed in both cases, and the appeals were transferred to the Kentucky Supreme Court. App. 7. In the Rehabilitator's case, Ernst & Young claimed that the FAA mandated arbitration and argued that the state rehabilitation court's "finding of reverse-preemption under the McCarran-Ferguson Act was erroneous." Ernst & Young Br. 14; *see also id.* at 8. Ernst & Young's briefing on the McCarran-Ferguson Act primarily argued that arbitration of an ordinary tort dispute arising out of the auditing contract would not "invalidate, impair, or supersede" Sections 10 and 40 of Kentucky's Liquidation Law, which grant the state court exclusive jurisdiction over delinquency proceedings and trump contrary contractual provisions. *Id.* at 8, 15–16. In response, the Rehabilitator argued that the Kentucky Liquidation Law (1) regulated the business of insurance; and (2) would be "impair[ed]" by the FAA. Rehabilitator Br. 9–12, 12–25. At oral argument, Ernst & Young emphasized that any Kentucky rule barring arbitration of the auditing

dispute here would not be aimed at "regulating the business of insurance." § 1012(b). In particular, Ernst & Young argued that it was contrary to *Fabe* for the trial court to hold that the McCarran-Ferguson Act encompasses a restriction on arbitrating tort claims brought by a rehabilitator against a former auditor. *See* Rehabilitator Opp. to Motion for Stay 5 n.2 (noting "E&Y's counsel's reference at oral argument" to *Fabe*).

3. On August 26, 2010, the Kentucky Supreme Court affirmed in the Rehabilitator's case. App. 2–3. The Kentucky Supreme Court agreed with Ernst & Young that the lower court had "failed to recognize the supremacy of the Federal Arbitration Act and its establishment of a national policy favoring the arbitration of disputes." App. 9. It also recognized that Ernst & Young's contracts each contained valid arbitration clauses that were generally enforceable under the FAA. App. 4–6, 8–11. But the Kentucky Supreme Court held that, due to the McCarran-Ferguson Act, those arbitration clauses were unenforceable.

First, the Kentucky Supreme Court considered and rejected Ernst & Young's argument that prohibiting arbitration here would not "regulat[e] the business of insurance." The Kentucky Supreme Court held that the Liquidation Law as a whole, "of which [Section 10] is a part, was enacted to regulate the 'business of insurance.'" App. 11. "The [Liquidation Law] is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company." App. 12. The Court did not evaluate, however, the purpose of the particular provisions that were arguably "invalidate[d],

impair[ed], or supersede[d]": Section 40's grant of exclusive jurisdiction to the state court over "all matters in any way relating to any delinquency proceeding," and Section 10's command that conflicting contractual provisions are unenforceable. Ky. Rev. Stat. Ann. §§ 304.33-010(6), 040(3)(a).

Second, the Court held that the FAA conflicted with this sweeping grant of exclusive jurisdiction to the state court. App. 13. "[A]n essential goal of the [Liquidation Law] is to promote consistent rulings in all matters that impact the rehabilitation of an insurance company," the Court explained. App. 15. The "strong grant of exclusive jurisdiction" is designed to avoid "[p]iecemeal adjudication and the potential for inconsistent verdicts." App. 16. Foreclosing arbitration of "all matters in any way relating to any delinquency proceeding" would eliminate the "potential for such inefficiencies." *Id.*; Ky. Rev. Stat. Ann. § 304.33-040(3)(a).

The Kentucky Supreme Court also held that arbitration would not "invalidate, impair, or supersede" the state court's exercise of exclusive jurisdiction. It recognized that a "trial court technically retains jurisdiction over [a] proceeding" during arbitration. App. 18. But "the trial court no longer retains the authority to 'determine all matters in any way related to the delinquency,'" as it must defer to the arbitrators' findings and rulings of law in many circumstances. *Id.* "Such a substantial reduction of the court's role in a process central to the rehabilitation of an insurance company is inconsistent" with the grant of exclusive jurisdiction. App. 19.

The Kentucky Supreme Court's reasoning thus boiled down to a syllogism: (1) Kentucky's Liquidation Law as a whole was enacted to regulate the business of insurance, and the grant of exclusive jurisdiction to the rehabilitation court over "all matters in any way relating to any delinquency proceedings" is part of that law; (2) that grant of exclusive jurisdiction would be "invalidate[d], impair[ed], or supersede[d]" by arbitration; *therefore*, (3) the FAA is reverse preempted as to arbitration of "a[ny] matte[r] in any way relating to any delinquency proceedings." App. 11, 13–14.

In the separate members' class action, the Kentucky Supreme Court reversed, holding that the arbitration clauses *were* enforceable. App. 2–3, 25. The McCarran-Ferguson Act was not at issue in that case. Rather, it focused on whether the class members were bound by the arbitration clause signed by AIK. App. 23–26. Finding that the class members were bound, the Kentucky Supreme Court remanded to compel arbitration. App. 25.

4. On September 15, 2010, Ernst & Young moved for the Kentucky Supreme Court to enter a stay in the Rehabilitator's suit pending a petition for certiorari. On October 15, 2010, the Kentucky Supreme Court denied that motion.

On November 22, 2010, Ernst & Young timely filed this petition for certiorari in the Rehabilitator's suit.

REASONS FOR GRANTING THE PETITION

This Court's review is warranted for two primary reasons. *First*, the Kentucky Supreme Court's

expansive interpretation of the McCarran-Ferguson Act is contrary to this Court's careful construction of that Act in *Fabe*. The decision below conflicts with *Fabe* in two important respects. First, by considering whether the Liquidation Law as a whole was enacted to regulate the "business of insurance," the Kentucky Supreme Court ignored this Court's clear direction in *Fabe* to consider specifically the application of the particular sections that face preemption — here, applying Kentucky's exclusive jurisdiction provisions to preclude the arbitration of disputes with third-parties having nothing to do with the insured-insurer relationship. Second, the Kentucky Supreme Court's methodological error in turn led it to a holding that cannot be reconciled with *Fabe*'s bottom line.

All nine Justices in *Fabe* agreed that the McCarran-Ferguson Act did not save the claims of ordinary creditors from being subordinated to federal claims under the federal priority statute. *Fabe*, 508 U.S. at 509 (majority op.); *id.* at 517 (Kennedy, J., dissenting). The arbitral dispute below is similarly removed from the "business of insurance" and the insured-insurer relationship. The Rehabilitator is simply seeking money damages from a third party, trying to make Ernst & Young a debtor. Indeed, if Ernst & Young brought a counterclaim against the Rehabilitator to recover unpaid fees, it would be a creditor — putting it in precisely the same position as the creditors that did not receive the benefit of reverse preemption in *Fabe*. It is immaterial that the Rehabilitator seeks to recover from Ernst & Young, rather than vice versa.

The decision below thus clearly conflicts with *Fabe*. The Kentucky Supreme Court prohibited

arbitration of "all matters in any way relating to any delinquency proceeding." This rule and the Kentucky Supreme Court's application of it here expand the McCarran-Ferguson Act far beyond the limits this Court has established. If left uncorrected, Kentucky and other states will be able to apply anti-arbitration state policies that the FAA was designed to displace — and that the McCarran-Ferguson Act was not designed to save. The McCarran-Ferguson Act is not even remotely as elastic as the Kentucky Supreme Court held.

Second, the Kentucky Supreme Court's opinion conflicts with the Sixth Circuit's decision in *AmSouth Bank v. Dale*, 386 F.3d 763 (6th Cir. 2004), which in turn conflicts with the Tenth Circuit's decision in *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1281 (10th Cir. 1998). In *AmSouth*, the Sixth Circuit held that the McCarran-Ferguson Act does *not* protect a state law prohibiting another forum from adjudicating "an ordinary suit against a tortfeasor by an insolvent insurance company." 386 F.3d at 783. While the forum-selection issue in *AmSouth* involved the choice between federal court and state court, rather than between arbitration and state court, courts have treated those issues interchangeably and the conflict is stark. Had the Kentucky Supreme Court applied the rule of law applied in *AmSouth*, it would have reversed, not affirmed, the judgment below.

The issues at stake here are also important. This Court has repeatedly considered cases to ensure that the important policies of the FAA are not frustrated by state courts hostile to arbitration. The benefits of arbitration are particularly important to accountants,

given the complexity and nuance of accounting and the temptation to sue the auditor, using 20/20 hindsight, when the audit client faces financial difficulty. To vindicate both this Court's decision in *Fabe* and the policies of the FAA, and to resolve this conflict among the lower courts, this Court should grant review.

I. THE KENTUCKY SUPREME COURT'S DECISION CONFLICTS WITH *FABE* AND EXPANDS THE MCCARRAN-FERGUSON ACT FAR BEYOND THE LIMITS THIS COURT HAS CAREFULLY CALIBRATED

A. The Kentucky Supreme Court's Focus on the Liquidation Law as a Whole Conflicts with *Fabe*'s Focus on the Application of the Particular Sections at Issue

The Kentucky Supreme Court erred off the bat in its analysis of whether the FAA was reverse preempted. In assessing whether McCarran-Ferguson protection applied here, the Kentucky Supreme Court focused on the purpose of the Liquidation Law as a whole — rather than the specific provisions of that law which would be "invalidate[d], impair[ed], or supersede[d]" by the FAA. § 1012(b). The Court explained, "the IRLL, of which [Section 10] is a part, was enacted to regulate the 'business of insurance.'" App. 11. The Liquidation Law "is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company." App. 12.

Fabe forecloses this approach. As here, *Fabe* assessed a provision that was part of a state's insurer liquidation law. *See* Ohio Rev. Code Ann. §§ 3903.02,

3903.42 (Anderson 1989). If location in the state insurance code was the "ultimate measure," *Fabe* could have been a very short opinion. It was not.

Rather than focusing on the purpose of that law as a whole — as the Kentucky Supreme Court did below — the Court in *Fabe* trained its focus on the specific section of that law that would be "invalidate[d], impair[ed], or supersede[d]." § 1012(b). Indeed, the *Fabe* majority focused even more narrowly on the purpose underlying the *different subsections* that faced possible preemption, and that narrow focus was reflected in the Court's holding. *Fabe* held that subsection (C), which granted priority to claims by policyholders, was enacted "for the purpose of regulating the business of insurance" — but subsection (E), which granted priority to general, third-party creditors over claims of the federal government, was not. *Fabe*, 508 U.S. at 493–94, 508–09; *see* Ohio Rev. Code Ann. § 3903.42(C), (E).

The Kentucky Supreme Court's analytical error of focusing on the Liquidation Law as a whole, rather than the particular application of the sections at issue, allowed the Kentucky Supreme Court to find that Sections 10 and 40 were entirely protected by the McCarran-Ferguson Act, despite their "extremely broad" reach to "all matters in any way relating to any delinquency proceedin[g]." App. 14; Ky. Rev. Stat. Ann. § 304.33-040(3)(a). This error thereby enabled the Kentucky Supreme Court to hold that its anti-arbitration implementation of the exclusive-jurisdiction provision could be applied to this garden-variety tort dispute between the insurer and a third party — without even considering that arbitrating this third-party tort suit would have, at most, an

extraordinarily attenuated impact on the relationship between policyholders and AIK. *See* App. 9–20. This is clearly contrary to *Fabe*'s command that the impact on the insured-insurer relationship must be "the focus" of the McCarran-Ferguson Act inquiry. 508 U.S. at 501; *see also Nat'l Securities*, 393 U.S. at 460.

B. The Kentucky Supreme Court's Holding that the McCarran-Ferguson Act Reaches Arbitration of Claims Between an Insolvent Insurer and a Third-Party Conflicts with *Fabe*'s Holding that It Does Not Reach Such Third-Party Claims

The Kentucky Supreme Court's methodological error in turn led to a deeper conflict with *Fabe*. At bottom, *Fabe* holds that the McCarran-Ferguson Act protects a provision of a state insurer liquidation law only to the extent it provides direct, targeted benefits to policyholders — and not to the extent it benefits ordinary, third-party creditors of an insolvent insurer. *Fabe*, 508 U.S. at 493–94. The Kentucky Supreme Court obliterated this distinction and held that the McCarran-Ferguson Act reaches arbitration of a dispute between an insolvent insurer and ordinary, third-party debtors. App. 19–20. This is squarely contrary to *Fabe*.

1. At issue in *Fabe* was one section of Ohio's insurer liquidation law, which ranked the priority of different creditors' claims against an insurer in state liquidation proceedings. *Fabe*, 508 U.S. at 493. The law conferred first priority to policyholders over all other creditors, but demoted claims by government entities behind ordinary creditors. Ohio Rev. Code Ann. § 3903.42(C), (E). The federal priority statute,

by contrast, generally confers first priority to United States government claims. 31 U.S.C. § 3713. The question presented was thus whether the McCarran-Ferguson Act reverse preempted the federal priority statute. In *Fabe*, the Supreme Court gave a carefully measured answer: Ohio's ranking of creditor priorities was "enacted for the purpose of regulating the business of insurance," and thus protected from preemption — but only to the extent it gave priority to policyholders specifically. 508 U.S. at 493. The same law was *not* aimed at regulating the business of insurance to the extent it granted priority to other, third-party creditors over the United States. *Id.* at 494.

The *Fabe* majority reasoned that "actual performance of an insurance contract" is part of the "business of insurance." *Id.* at 505. Granting policyholders first priority over the United States gave policyholders a targeted benefit, directly increasing the likelihood that there would be actual performance, *i.e.*, that "policyholders ultimately will receive payment on their [insurance] claims." *Id.* at 506. But granting priority to other creditors did no such thing. "[E]very preference accorded to the creditors of an insolvent insurer ultimately may redound to the benefit of policyholders by enhancing the reliability of the insurance company," the Court recognized. *Id.* at 508. But such "indirect effects" on the policyholder-insurer relationship were "too tenuous" to be protected by the McCarran-Ferguson Act. *Id.* at 509.

2. The Kentucky Supreme Court's holding cannot be reconciled with *Fabe*. The Kentucky Supreme Court reasoned that the Liquidation Law as a whole

was enacted to "regulat[e] the business of insurance," and arbitration would conflict with the rehabilitation court's exclusive jurisdiction over "all matters in any way related to any delinquency proceedings." App. 11, 13; Ky. Rev. Stat. Ann. § 304.33-040(3)(a). And it applied this rule to conclude that the McCarran-Ferguson Act protects its prohibition against arbitrating this garden-variety tort claim against a third party. App. 19.

This result is squarely opposed to *Fabe*, as the relationship between Respondents and Petitioners here is the mirror image of the relationship between the creditors and the insolvent insurer, which *Fabe* held not to be "regulat[ion of] the business of insurance." 508 U.S. at 508–09. Just like *Fabe*, which involved claims between third parties and the insolvent insurer, this case involves claims between third parties and the insolvent insurer (via the rehabilitator). And although the direction of the claims is different -- the third-parties were creditors in *Fabe*, while the Rehabilitator seeks to make Ernst & Young a debtor here — that is a distinction without a difference. Indeed, if Ernst & Young sought to collect unpaid fees from the Rehabilitator — or if Ernst & Young filed a counterclaim in this very tort suit — it would become a creditor Its claims would thus have precisely the same attenuated relationship to policyholders that *Fabe* found to be beyond the scope of McCarran-Ferguson protection.

A creditor/debtor distinction is not only functionally meaningless, but also it is senseless under *Fabe*'s rationale. Whether the third party is a debtor or a creditor, either way a resolution of the third-party claims would only impact policyholders

indirectly, via the insurer's bottom line. And *Fabe* squarely establishes that such an impact on an insurer's balance sheet is not enough to trigger McCarran-Ferguson Act protection. "'[E]very business decision made by an insurance company has some impact on its reliability . . . and its status as a reliable insurer.'" *Fabe*, 508 U.S. at 508 (quoting *Group Life & Health Ins. Co. v. Royal Drug*, 440 U.S. 205, 216–17 (1979)). But such "indirect effects" on the insured-insurer relationship via an improvement to the insurer's balance sheet are insufficient to trigger reverse preemption. *Id.* at 509; *see also Royal Drug*, 440 U.S. at 214, 216–17. Accordingly, the Kentucky Supreme Court's conclusion that the McCarran-Ferguson Act reaches such third-party claims is contrary to *Fabe*.

Indeed, the question of *whether to arbitrate* an ordinary tort suit between an insolvent insurer and a third party has even less to do with "regulating the business of insurance" than the third-party creditor preferences that *Fabe* held were beyond the McCarran-Ferguson Act's reach. *Fabe*, 508 U.S. at 493–94. Ohio's statute ranked the order of various creditors of an insolvent insurer, establishing a substantive rule that plausibly could impact the creditworthiness of that insurer, albeit "indirect[ly]." *Id.* at 508–09. By contrast, this is a tort suit about auditing, a topic far afield from the insured-insurer relationship. Furthermore, prohibiting arbitration of this dispute "does not entail any consequential restriction on substantive rights". *McMahon*, 482 U.S. at 232. It merely regulates whether the dispute will be resolved "in an arbitral, rather than judicial forum." *McMahon*, 482 U.S. at 229–30 (quotation marks omitted).

To be sure, to the extent Kentucky wanted to apply its anti-arbitration policies to coverage disputes between policyholders and the insurer, it could do so under *Fabe*: that rule would govern the insured-insurer relationship. *E.g., Am. Bankers Ins. Co. v. Inman*, 436 F.3d 490, 494 (5th Cir. 2006). But it is just as clear under *Fabe* that Kentucky cannot extend its anti-arbitration policies to claims between a rehabilitator and ordinary third parties, like Petitioners. It simply does not matter to a policyholder's relationship with its insurer whether, if the insurer becomes insolvent, enters state liquidation proceedings, and the Rehabilitator sues a third party in tort, that suit will be heard by an arbitrator or a state court judge.

3. The Kentucky Supreme Court's decision would fare even worse under the *Fabe* dissent. Justice Kennedy, joined in dissent by Justices Scalia, Souter, and Thomas, advocated a narrower reading of the McCarran-Ferguson Act. In their view, Ohio's entire priority statute was unprotected, as it was "too removed from the contractual relationship between the policyholder and the insurance company." *Fabe*, 508 U.S. at 517 (Kennedy, J., dissenting). "This is not the regulation of the business of insurance, but the regulation of creditors' rights in an insolvency proceeding." *Id.* at 513. Under the dissent's reasoning, the entire subject of insurer liquidation would be too far removed from the business of insurance.

All nine Justices in *Fabe* agreed, however, that not every provision a state includes in an insurer liquidation law is enacted to "regulat[e] the business of insurance." Rather, provisions in state insurer

liquidation laws that merely have a generalized impact on the reliability of an insurer are "too tenuous" and "too removed" from regulation of the core business of insurance to be protected by the McCarran-Ferguson Act. *Id.* at 509 (majority op.); *id.* at 517 (Kennedy, J., dissenting).

This Court's earlier decisions also consistently warn against reading the McCarran-Ferguson Act so broadly that it protects laws or practices that have only a generalized impact on the insurer's balance sheet. *See, e.g., Nat'l Securities*, 393 U.S. at 460; *Pireno*, 448 U.S. at 132. For example, in *Royal Drug*, this Court held that an insurer's "arrangements for the purchase of goods and services" are not part of the "business of insurance." *Royal Drug*, 440 U.S. at 214. So long as the insurer provided the coverage it promised, policyholders were "basically unconcerned" with the insurer's behind-the-scenes arrangements with third parties for goods or services. *Id.* Although those contracts "may well be sound business practice, and may well inure ultimately to the benefit of policyholders in the form of lower premiums," these indirect impacts were insufficient to be shielded by the McCarran-Ferguson Act. *Id.*

C. The Kentucky Supreme Court's Conflict with *Fabe* Runs Deeper Still

1. The Kentucky Supreme Court's holding also fails when viewed in light of the three-factor *Fabe/Pireno* test. Kentucky's refusal to permit arbitration of the dispute between the Rehabilitator and Ernst & Young does not "regulat[e] the business of insurance" because it does not "possess the 'end, intention, or aim' of adjusting, managing, or

controlling" (1) the transfer of risk; (2) another "integral part of the policy relationship between the insurer and the insured"; or (3) a practice that is limited to the insurance industry. *Fabe*, 508 U.S. at 505; *Pireno*, 458 U.S. at 129.

First, foreclosing arbitration of an insolvent insurer's suit against a former auditor is not even arguably aimed at "transferring or spreading a policyholder's risk" from the insured to the insurer. *Pireno*, 458 U.S. at 129. The underlying tort dispute over auditing has nothing to do with the transfer of risk — and the question whether to arbitrate that dispute is even further removed from the "true underwriting of risks, the one earmark of insurance." *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 73 (1959).

Second, the choice of forum for hearing a tort suit between a rehabilitator and an auditor is surely not an "integral part of the policy relationship between the insurer and the insured." *Pireno*, 458 U.S. at 129. Indeed, *Royal Drug* established that "arrangements for the purchase of goods and services" are not part of the "business of insurance" at all. *Royal Drug*, 440 U.S. at 214. Although the contractual relationship between an insurer and third party providers of goods or services "may well inure ultimately to the benefit of policyholders in the form of lower premiums," the policyholder is "basically unconcerned" about such matters. *Id.* Policyholders have even less concern for whether a tort suit arising from an insurer's business relationship with a third party will be arbitrated. The policyholder's concern "is *whether* his claim is paid, not *why* it is paid" — much less how the insurer's assets and liabilities are accounted for and whether

lawsuits arising from that accounting are heard by an arbitrator. *Pireno*, 448 U.S. at 132; *see also Nat'l Securities*, 393 U.S. at 460.

Third, the refusal to permit arbitration here is obviously not "limited to entities within the insurance industry." *Pireno*, 458 U.S. at 132. It involves "third parties wholly outside the insurance industry" — namely, Ernst & Young. *Id.*

A rule barring arbitration of this ordinary tort suit between a rehabilitator and a third party thus does not remotely constitute a law that "possess[es] the 'end, intention, or aim' of adjusting, managing, or controlling" the "business of insurance." *Fabe*, 508 U.S. at 505. "Insurance companies may do many things which are subject to paramount federal regulation; only when they are engaged in the 'business of insurance' does the statute apply." *Nat'l Securities*, 393 U.S. at 459–60. After all, the statute "exempts the 'business of insurance' and not the 'business of insurance companies.'" *Royal Drug*, 440 U.S. at 217. Arbitration of this tort suit falls in the latter category, and thus Kentucky's anti-arbitration rule here is not protected by the McCarran-Ferguson Act.

2. The Kentucky Supreme Court's same misreading of the Act can also be seen as an overly broad interpretation of the statutory phrase "invalidate, impair, or supersede." § 1012(b). Arbitration clauses are generally enforceable, irrespective of a court's exclusive jurisdiction, because arbitration does not alter "substantive rights," the scope of the relief available, or eliminate court review of the arbitral award; it merely regulates the choice of

initial forum. *McMahon*, 482 U.S. at 229–30. Of course, the Kentucky Supreme Court is free, as a matter of Kentucky law, to read Section 40's grant of exclusive jurisdiction to state courts as prohibiting arbitration of "all matters in any way related to any delinquency proceedings." Ky. Rev. Stat. Ann. § 304.33-040(3)(a). But the meaning of "invalidate, impair, or supersede" is a question of federal law. *See Humana*, 525 U.S. at 307–10. By interpreting Kentucky's exclusive jurisdiction provision as an anti-arbitration rule that reaches matters so far removed from core rehabilitation proceedings, the Kentucky Supreme Court ensured that "any 'impairment'" of such proceedings by allowing arbitration would be "most indirect." *Humana*, 525 U.S. at 311 (quoting *Nat'l Securities*, 393 U.S. at 463). That is insufficient.

In short, the Kentucky Supreme Court applied a test that *Fabe* rejected to reach a result that *Fabe* foreclosed: that the McCarran-Ferguson Act protects a state-law ban against arbitrating "all matters in any way relating to any delinquency proceedings," including an ordinary tort suit between an insolvent insurer and a third party. *Fabe* establishes that the Act is nowhere near that broad. The Kentucky Supreme Court's decision therefore merits this Court's review.

II. THE KENTUCKY SUPREME COURT'S HOLDING IS SHARPLY AT ODDS WITH THE SIXTH CIRCUIT'S, REFLECTING A DIVIDE AMONG THE CIRCUIT COURTS OF APPEALS

1. The Kentucky Supreme Court's interpretation of the McCarran-Ferguson Act also conflicts with the

Sixth Circuit's. In *AmSouth Bank v. Dale*, 386 F.3d 763 (2004), as here, an insurer was in delinquency proceedings under a state liquidation law, which broadly prohibited any suit against the insurer in any forum other than the state court — indeed, in *AmSouth*, a state court entered an anti-suit injunction expressly prohibiting any such suit. *Id.* at 780. And as here, a dispute arose between the state rehabilitator and a third party who had provided professional services to the insurer — here, an auditor, there, banks. After the rehabilitator threatened to sue them in tort, the banks sought a declaratory judgment in federal court that there was no tort liability. *Id.* at 770–72. The rehabilitator invoked the McCarran-Ferguson Act, arguing that the state liquidation law's exclusive jurisdiction provision, backed by the anti-suit injunction, reverse-preempted the federal courts from exercising their diversity jurisdiction over the dispute. *Id.* at 780–81.

The Sixth Circuit disagreed. "[A]n ordinary suit against a tortfeasor by an insolvent insurance company implicates a 'regulation of the business of insurance' only in the attenuated fashion rejected in *Fabe*." *Id.* at 783. The injunction against litigation in any forum other than the state court "would only be a regulation of the business of insurance to the extent it protected the assets of the insurance company from suit." *Id.* Furthermore, there was no "impairment," within the meaning of the McCarran-Ferguson Act, because "the integrity of the core liquidation proceedings [was not] attacked." *Id.*

On parallel facts here, the Kentucky Supreme Court reached the opposite result. To the Kentucky Supreme Court, "an ordinary suit against a tortfeasor

by an insolvent insurance company" *does* involve "regulation of the business of insurance." App. 11. And adjudication by another forum *does* constitute an "impairment," within the meaning of the McCarran-Ferguson Act, because arbitration would conflict with an "an essential goal" of the delinquency proceedings. App. 13–15.

Although this suit involves arbitral jurisdiction under 9 U.S.C. § 2, while *AmSouth* involves federal court jurisdiction under 28 U.S.C. § 1331, nothing in either decision suggests that this distinction is material. To the contrary, *AmSouth* treats arbitration-versus-state-court cases and federal-versus-state-court cases as fungible precedents addressing whether the McCarran-Ferguson Act saves from preemption a state law's preference for an exclusive state-court forum. *See AmSouth*, 386 F.3d at 781–82. The distinction is also immaterial under the exclusive-jurisdiction provisions here and in *AmSouth*: Both require that state courts — and only state courts — adjudicate the tort suit against the third party. Here and in *AmSouth*, the third party nonetheless invoked a general federal law to transfer the suit to another forum. The Kentucky Supreme Court held that the McCarran-Ferguson Act stood as a bar to this effort. The Sixth Circuit held that it did not.

2. Contrary to *Fabe* and *AmSouth*, the Tenth Circuit joins the Kentucky Supreme Court in holding that the McCarran-Ferguson Act protects state law provisions barring other forums from hearing an ordinary tort suit between an insolvent insurer and a third party. *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1281 (10th Cir. 1998). In

Davister, as here, the underlying dispute had nothing to do with the transfer of risk nor was it an "integral part" of the policyholder-insurer relationship — it arose from a real estate deal — and it involved an entity wholly outside the insurance industry — a realty company. *Id.* at 1278. And as here, the question *whether to arbitrate* that dispute was even further removed from the "business of insurance." Nonetheless, the Tenth Circuit found reverse preemption. *Id.* at 1281. The court reasoned that arbitration would "impair the progress of the orderly resolution of all matters involving the insolvent company" and a win in litigation would improve the insurer's bottom line. *Id.* The Court admitted that these benefits would inure equally "to other creditors," but it found that this did not "dimins[h] or denigrat[e]" its conclusion that the law regulated the business of insurance. *Id.*

Judge Lucero dissented, pointing to *Fabe*'s holding that the McCarran-Ferguson Act does not protect state liquidation laws to the extent they merely provide generalized, indirect benefits to policyholders. *Id.* at 1282. Judge Lucero warned that "[t]o bring this dispute within the reach of McCarran-Ferguson reverse pre-emption would swallow the very fine distinction set forth by *Fabe*'s majority, potentially precluding federal jurisdiction over any dispute involving an insolvent insurance company." *Id.* at 1283. The Tenth Circuit majority did not heed this warning and neither did the Kentucky Supreme Court.

3. The conflict between this case and *Davister*, on one hand, and *AmSouth* on the other, marks the latest — and sharpest — divide between two

divergent lines of opinion among the Courts of Appeals as to the scope of the McCarran-Ferguson Act's protection for state liquidation laws that restrict litigants' access to other forums. This divide has been noted repeatedly. *E.g.*, *AmSouth*, 386 F.3d at 782 (describing two "different line[s] of cases"); *Nw. Corp. v. Nat'l Union Fire Ins. Co.*, 321 B.R. 120, 125–26 (D. Del. 2005) ("the case law runs both ways").

The leading case for an expansive reading of the McCarran-Ferguson Act is *Munich American Reinsurance Co. v. Crawford*, 141 F.3d 585 (5th Cir. 1998). *See Davister*, 152 F.3d at 1280–82 (following *Munich*); *AmSouth*, 386 F.3d at 783 (rejecting *Munich*). In *Munich*, the Fifth Circuit held that Oklahoma's insurer liquidation law "reverse preempted" arbitration of a suit in which an insolvent insurer sued a reinsurer for damages. *Munich*, 141 F.3d at 590. Like the Kentucky Supreme Court, the Fifth Circuit concluded that Oklahoma's "comprehensive regulatory scheme, viewed in its entirety," was aimed at regulating the business of insurance. *Id.* at 592. And like the Kentucky Supreme Court, the Fifth Circuit interpreted "impair" broadly, concluding that Oklahoma law barred arbitration, without examining the relationship between the choice of forum and the "business of insurance." *Id.* at 594–95.

The result in *Munich* is less troubling than the decisions below and in *Davister*, however. Unlike this suit and *Davister*, which involve run-of-the-mill tort suits against third parties outside the insurance industry, *Munich* involved a dispute between an insurer and a reinsurer. *See id.* at 587–88. The relationship between the parties was thus analogous

to that between a primary policyholder and a primary insurer, and the dispute was "limited to entities within the insurance industry." *Pireno*, 458 U.S. at 129. The nexus to the "business of insurance" is thus substantially tighter in *Munich* than here.

The Second Circuit has also held that the McCarran-Ferguson Act reverse-preempted the FAA in the context of a reinsurance dispute, and it did so in a case involving the same Kentucky exclusive jurisdiction provisions at issue here. *Stephens v. Am. Int'l Ins. Co.*, 66 F.3d 41, 42 (2d Cir. 1995).[1] Like *Munich*, *Stephens* contains language suggesting that the McCarran-Ferguson Act broadly protects state anti-arbitration rules in insurer liquidation laws on the theory that it is "crucial" to the insured-insurer relationship that, "in the case of insolvency, the insurance company will be liquidated in an organized fashion." *Id.* at 44–45. But *Stephens* is more clearly bound to its facts. Indeed, the Second Circuit's analysis of the three-factor *Fabe/Pireno* test had everything to do with reinsurance: The court explained that (1) the insurer-reinsurer relationship is "principally the same" as that "between an original policyholder and an insurer, as both center around the transfer of risk"; (2) "reinsurance is not merely 'an integral part of the policy relationship between the insurer and insured,' it *is* the policy relationship between the two parties"; and (3) reinsurance is

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[1] Kentucky's Liquidation Law has been since amended to address the reinsurance issue raised in *Stephens*. *See* Ky. Rev. Stat. Ann. § 304.33-010(6) (2010); 1996 Ky. Acts ch. 183, § 1. This change is immaterial here, however.

"'limited to entities within the insurance industry.'" *Id.* at 44 (quoting *Pireno*, 458 U.S. at 129).

The danger of *Munich* (and to a lesser extent, *Stephens*) thus arises not from its result, but from its rationale: that the McCarran-Ferguson Act protects any provision of a state liquidation law that bars access to any forum other than state courts. *Munich*, 141 F.3d at 592–95; *see also Stephens*, 66 F.3d at 44–45. Under this rule, it is immaterial how indirectly application of such an access-control law impacts the insured-insurer relationship. In *Davister*, the Tenth Circuit took *Munich*'s reasoning and ran with it, foreclosing arbitration of an ordinary tort suit between an insolvent insurer a third party outside the insurance industry. *Davister*, 152 F.3d at 1281. The Kentucky Supreme Court below did the same.

By contrast, the Sixth Circuit has expressly rejected *Munich*'s rule of law as "overly expansive." *AmSouth*, 386 F.3d at 783. So has the Fourth Circuit. In *Gross v. Weingarten*, 217 F.3d 208 (4th Cir. 2000), an insolvent insurer brought suit in federal court against a bank, but when the bank counterclaimed, the insurer pointed to *Munich* and asserted that federal jurisdiction was barred by the state's "efforts to establish a single equitable proceeding to liquidate or rehabilitate insolvent insurers." *Id.* at 222. The Fourth Circuit had none of it. The court rejected *Munich*'s reasoning because it "proves too much." *Id.* Instead, the Fourth Circuit held that exercise of concurrent jurisdiction over the bank's counterclaims did not "invalidate, impair, or supersede" the state's efforts to concentrate proceedings in the state liquidation court, as the banks could not enforce any

judgment on their counterclaims without participating in the liquidation. *Id.*

In *Garcia v. Island Program Designer, Inc.*, 4 F.3d 57 (1st Cir. 1993) (Breyer, J.), the First Circuit adopted a similarly measured approach, albeit on a different fact pattern. In *Garcia*, the First Circuit held that Puerto Rico could not penalize the federal government for failing to comply with a filing deadline for creditors of an insolvent insurer by sending federal claims "to the end of the priority queue." *Id.* at 58.[2] The filing deadline "helps policyholders only to the extent that (and in the same way as) it helps all creditors," by "bring[ing] about more speedy, orderly liquidation proceedings." *Id.* at 62. Without it, liquidation would become "slightly more difficult." *Id.* The deadline thus "provides policyholders with only indirect, speculative benefit of the kind that the *Fabe* Court found far too tenuous to prevent pre-emption." *Id.* The anti-arbitration rule here is clearly different from the filing deadline in *Garcia*. But if the Kentucky Supreme Court had employed similar reasoning, however — refusing to protect an "indirect, speculative benefit" shared by policyholders and other creditors — the Kentucky Supreme Court would likely have reversed, not affirmed.

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[2] Puerto Rico is a "State" for purposes of the McCarran-Ferguson Act. 15 U.S.C. § 1015.

III. THIS IS AN EXCELLENT VEHICLE FOR RESOLVING AN IMPORTANT QUESTION REGARDING THE INTERPLAY BETWEEN THE MCCARRAN-FERGUSON ACT AND THE FAA

1. The decision below not only conflicts with *Fabe* and *AmSouth*, but also upsets the balance between the McCarran-Ferguson Act and the FAA and undermines the important policies of the FAA. The question of whether an ordinary tort suit between a rehabilitator and a potential third-party debtor should be arbitrated is far from the core of the McCarran-Ferguson Act — indeed, arbitrability of such a dispute is essentially irrelevant to policyholders.

But this question of arbitrability lies at the heart of the FAA. Congress enacted the FAA for the "central purpose" of "ensur[ing] that private agreements to arbitrate are enforced according to their terms." *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 53–54 (1995) (quotation marks omitted). This pro-arbitration federal policy marked a dramatic shift away from "centuries of judicial hostility to arbitration agreements." *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510 (1974). "[F]irst and foremost," the FAA's aim was to "change this antiarbitration rule." *Allied-Bruce*, 513 U.S. at 270–71 (quotation marks omitted).

The Kentucky Supreme Court evinced precisely the judicial hostility to arbitration that Congress intended the FAA to override. The Kentucky Supreme Court explained that arbitration would lead to "[p]iecemeal adjudication" and a "potential for

inconsistent verdicts," and would unduly restrict the state court's review. App. 16. Indeed, it was this hostility to arbitration's perceived tendency to interfere with ordinary judicial administration — not anything having to do with the business of insurance — that drove the court's reasoning.

This Court has rejected these very same reasons as a basis for refusing arbitration. "[F]ederal law *requires* piecemeal resolution when necessary to give effect to an arbitration agreement." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S . 1, 20 (1983). An arbitration clause must be enforced as drafted even when arbitration would bifurcate otherwise intimately intertwined proceedings, thereby leading to inefficiency and potential inconsistencies. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218, 221–22 (1985). The intent of the parties, not efficiency, is the paramount concern. *Id.* at 221. And "although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of [a] statute." *McMahon*, 482 U.S. at 232. The Kentucky Supreme Court's decision does little to further Congress's goals in enacting the McCarran-Ferguson Act — but it directly counters the policies that undergird the FAA.

This Court has routinely intervened to ensure that judicial skepticism of arbitration does not frustrate the objectives of the FAA and the value of bargained-for agreements to arbitrate. Arbitration is particularly important to the accounting profession, as many accounting disputes involve the application of professional judgment to highly complex and indeterminate rules. *See Shalala v. Guernsey Mem'l*

Hosp., 514 U.S. 87, 101 (1995). At the same time, auditors are attractive litigation targets in hindsight whenever an audit client has unexpected financial difficulties. *See, e.g., Bily v. Arthur Young & Co.*, 834 P.2d 745, 763 (Cal. 1992).

2. This is an unusually good vehicle for addressing whether the McCarran-Ferguson Act reverse preempts the FAA as to arbitration of an ordinary tort suit between a rehabilitator and a third party. But for the Kentucky Supreme Court's interpretation of the McCarran-Ferguson Act, the FAA would indisputably command arbitration. In the separate class action suit brought against Ernst & Young, in which the McCarran-Ferguson Act was not invoked, the Kentucky Supreme Court held that the FAA compelled arbitration of precisely the same arbitration clause. App. 25. In the Rehabilitator's suit, by contrast, the Kentucky Supreme Court relied exclusively on McCarran-Ferguson Act as the basis for refusing to arbitrate. App. 19–20. This petition thus squarely presents the question of whether the Kentucky Supreme Court's expansive interpretation of the McCarran-Ferguson Act can be reconciled with *Fabe* — and whether its anti-arbitration policies are immune from the FAA's command.

CONCLUSION

For the foregoing reasons, this Court should grant the petition for certiorari.

RESPECTFULLY SUBMITTED

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Appendix E

Affidavit of David S. Meyer, dated April 18, 2005, attaching Engagement Letter containing mandatory arbitration clause, dated July 22, 2002 ..... App-63

Appendix A

Rendered: Aug. 26, 2010

SUPREME COURT OF KENTUCKY

Nos. 2007-SC-000770-TG, 2007-SC-000936-TG

ERNST & YOUNG, LLP & David S. Meyer,

Appellants

v.

Sharon P. CLARK (In Her Official Capacity as Commissioner for the Kentucky Department of Insurance and Rehabilitator of AIK Comp); Stephen P. Lattanzio; Actuarial & Technical Solutions, Inc.; and John and Jane Does, all Unknown Actuaries and Accountants,

Appellees

and

ERNST & YOUNG, LLP,

Appellant

v.

APPALACHIAN REGIONAL HEALTHCARE, INC.; Apollo Oil, LLP; Art's Electric, Inc.; Crittenden Health Systems; European Design, Inc.; Fischer Special Manufacturing Company; Gallatin Health Care, LLC; Hopewell Farm, LLC; Louden & Company, LLC; M & M Cartage, Inc.; Modco Transport; and Pattie A. Clay Regional Medical Center,

Appellees

Opinion of the Court by Justice VENTERS

Affirming in Part and Reversing in Part

This appeal arises out of the insolvency of AIK Comp, a workers' compensation self-insurance group, and the efforts of the Rehabilitator appointed pursuant to Kentucky's "Insurers Rehabilitation and Liquidation Law"[1] (IRLL) to assert tort claims on behalf of AIK Comp against Appellants, Ernst & Young LLP, and others. Similar claims against Appellants were also asserted by the individual members of AIK Comp[2] in a class action. The Franklin Circuit Court entered orders in each case denying Ernst & Young's motion to enforce contractual provisions calling for such claims be submitted to "binding arbitration." Appeals from those orders were consolidated and transferred to this Court. Two issues are presented: first, whether the arbitration agreements in Ernst & Young's contracts with AIK Comp may be enforced against the Rehabilitator; and second, whether the same arbitration agreements force the plaintiffs in the class action to arbitrate their claims against Ernst & Young.

We hold that the arbitration agreements are not enforceable over the Rehabilitator's objection and affirm that order of the Franklin Circuit Court. However, for reasons set forth in section III of this

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[1] KRS 304.33-010 to 304.33-600.

[2] There are numerous plaintiffs in the class action. These plaintiffs include: Appalachian Regional Healthcare, Inc.; Apollo Oil, LLP; Art's Electric, Inc.; Crittenden Health Systems; European Design, Inc.; Fischer Special Manufacturing Company; Gallatin Health Care, LLC; Hopewell Farm, LLC; Louden & Company, LLC; M & M Cartage, Inc.; Modco Transport; and Pattie A. Clay Regional Medical Center.

opinion, we conclude that the circumstances that require the Rehabilitator's claims to remain in the Franklin Circuit Court are not applicable to the class action claims, and thus those claims are subject to the arbitration requirements. Accordingly, we reverse that order of the Franklin Circuit Court.

I. FACTUAL AND PROCEDURAL BACKGROUND

AIK Comp (formerly known as Associated Industries of Kentucky Selective Self-Insurance Fund) is a workers' compensation self-insured group organized under KRS 342.350,[3] to provide its member-employers with the workers' compensation insurance required by KRS 342.340. At all times relevant to this action, KRS 342.347(1)[4] mandated the Commissioner of the Kentucky Department of Insurance (now the Executive Director of the Kentucky Office of Insurance) to periodically examine the financial condition of workers' compensation self-insured groups. KRS 342.347(2) required each self-insurance workers' compensation group, including AIK Comp, to be annually audited by an independent certified public accountant and to file with the Commissioner a detailed statement of its financial condition as disclosed by the audits. The statute specified the

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[3] In 2005, after the failure of AIK Comp and after the audits that are the subject of this litigation, the General Assembly enacted KRS 304.50-010 to 304.50-160 which recodified, and in some instances modified, the regulation of workers' compensation self-insured groups previously covered by KRS 342.350.

[4] Note that KRS 304.50-075, effective March 1, 2005, specifically calls for review of each workers' compensation self-insured groups' financial condition every four years by the Executive Director of the Office of Insurance.

particular information to be included in the annual statement of financial condition.[5] KRS 342.347(5) required the insurance Commissioner to "make such recommendations to the Governor and legislative committees as may be appropriate to strengthen the oversight of self-insureds so that payment of liabilities to workers under this chapter is assured."

In 1999 and each year thereafter through 2003, the Chief Executive Officer of AIK Comp, Maurice Turner, and a representative from Ernst & Young, David S. Meyer, executed a written agreement (the "engagement letters") whereby Ernst & Young LLP, a certified public accounting and auditing firm, agreed to provide accounting services for AIK Comp to satisfy the statutory auditing and reporting requirements. Each engagement letter called for Ernst & Young to audit AIK Comp's finances for the previous fiscal year. A mediation and arbitration clause was included in the first engagement letter, and was thereafter incorporated by reference in the subsequent engagement letters. For the audits completed for fiscal years 1998 to 2001, the arbitration clause stated as follows:

> [a]ny controversy or claim arising out of or relating to the services covered by this letter or hereafter provided by us to the Company (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Company or of Ernst & Young LLP) shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding

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[5] KRS 304.50-110 now provides substantially similar reporting requirements.

> arbitration, in accordance with the dispute resolution procedures set forth in the attachment to this letter. Judgment on any arbitration award may be entered in any court having proper jurisdiction.

The dispute resolution procedures set forth in the attachment included a choice of law provision requiring that any dispute regarding the validity of the arbitration clause would "be governed by the Federal Arbitration Act."

In July 2002, Ernst & Young and AIK Comp executed another engagement letter, which applied to the audits for fiscal years 2002 and 2003 and contained the following, slightly different arbitration provision:

> [a]ny controversy or claim arising out of or relating to services covered by this letter or hereafter provided by us for the Fund or at its request (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Fund or of Ernst & Young LLP, *or involving any person or entity for whose benefit the services in question are or were provided),* shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitration, in accordance with the dispute resolution procedures set forth in the attachment to this letter. Judgment on any arbitration award may be entered in any court having jurisdiction. (emphasis added.)

The latter arbitration clause retained the choice of law provision requiring that any dispute "shall be governed by the Federal Arbitration Act." Later in 2003, Ernst & Young resigned as AIK Comp's auditor prior to

completion of the contract as outlined in the final engagement letter.

All of the audits completed by Ernst & Young for statutory submission by AIK Comp to Kentucky's insurance regulators indicated that the group was financially sound. The audits showed that AIK Comp maintained a positive fund surplus with sufficient assets and reserves to cover the liabilities that may arise from future workers' compensation claims. However, in 2004, a financial examination by a different accounting firm revealed that AIK Comp was in a deficit position and was unable to pay its claims. AIK Comp was subsequently placed in rehabilitation by order of the Franklin Circuit Court pursuant to KRS Chapter 304, and accordingly, a Rehabilitator[6] was appointed. The discovery of AIK Comp's insolvency brought into question the accuracy of the Ernst & Young audit reports and the competence of those who prepared them.

Eventually, a Reorganization Plan for AIK Comp was agreed upon by the Rehabilitator and by the numerous parties that had intervened in the rehabilitation. The Reorganization Plan was approved by the Franklin Circuit Court in December 2005. To finance most of AIK Comp's $90,000,000 deficit and to assure payment of the claims of injured workers, the Rehabilitation Plan required that the employers that comprised the membership of AIK Comp be assessed a

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[6] Martin Koetters was the first Rehabilitator. He was succeeded by R. Glenn Jennings, who was succeeded by Julie Mix McPeak. Clark then replaced McPeak. To avoid confusion, we will use feminine pronouns to refer to the Rehabilitator throughout the opinion since Sharon P. Clark currently holds the position.

proportional share of the deficit. The Reorganization Plan also provided for the Rehabilitator to "aggressively pursue" claims against those "[s]he holds responsible for the current problems faced by AIK Comp." Thus, pursuant to the Reorganization Plan and her power under KRS 304.33-160, the Rehabilitator filed suit against Ernst & Young and other parties[7] in the Franklin Circuit Court alleging that Ernst & Young's audits had been negligently prepared, and had concealed AIK Comp's declining financial condition. In addition, the members of AIK Comp that paid assessments to cover the financial deficit brought a separate suit against Ernst & Young and others in the Franklin Circuit Court, claiming that the assessments were necessitated by the alleged misrepresentations, omissions, and false statements made in the audits. The members' suits were consolidated into a class action.

In response, Ernst & Young filed motions in both cases to stay the proceedings and to compel arbitration in accordance with the arbitration clauses contained in the engagement letters described above. The Franklin Circuit Court denied the motions. Ernst & Young appealed. The Rehabilitator moved to transfer the appeal of her case from the Court of Appeals to this Court. Ernst & Young subsequently moved to transfer the appeal involving the members of AIK Comp to this Court. We granted the motions to transfer and consolidated the appeals.

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[7] The Rehabilitator filed suit against Ernst & Young employee David S. Meyer, Actuarial & Technical Solutions, Inc. which performed actuarial services for AIK Comp between 1998 and 2003, and its agent Stephen Lattanzio.

At the outset, we note that the arbitration agreements entered into between Ernst & Young and AIK Comp are facially valid. *See General Steel Corp. v. Collins,* 196 S.W.3d 18, 20 (Ky. App. 2006) (holding that the validity of an arbitration agreement must be determined as a threshold matter) (citing *First Options of Chicago, Inc. v. Kaplan,* 514 U.S. 938 (1995)). The engagement letters clearly contain agreements to arbitrate, and there is every indication that the elements of valid contract formation were satisfied.

Because the agreements explicitly require that disputes be governed by the Federal Arbitration Act, 9 U.S.C. § 1, *et. seq.*, we need not consider Kentucky's Uniform Arbitration Act, KRS 417.045 *et. seq.*[8] *Conseco Finance Servicing Corp. v. Wilder,* 47 S.W.3d 335, 341 (Ky. App. 2001) (citing *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University,* 489 U.S. 468 (1989)) (stating that choice of law provisions in arbitration agreements are to be generally upheld).

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[8] Under the Kentucky's "Uniform Arbitration Act", KRS 417.045-417.240, the arbitration clauses at issue would be unenforceable since they do not specifically provide for the arbitration to occur in this state. *Ally Cat, LLC v. Chauvin,* 274 S.W.3d 451, 455 (Ky. 2009) (holding that the plain language of KRS 417.200 only allows enforcement of arbitration agreements which specifically state that the arbitration is to be held in Kentucky). *Ally Cat* has no applicability to an arbitration agreement governed exclusively by the Federal Arbitration Act.

II. THE ARBITRATION AGREEMENT BETWEEN ERNST & YOUNG AND AIK COMP IS NOT ENFORCEABLE AGAINST THE REHABILITATOR

Ernst & Young first argues that the Franklin Circuit Court erroneously denied its motion to compel arbitration of the Rehabilitator's suit. The Franklin Circuit Court order held that arbitration could not be compelled against the Rehabilitator because: 1) the IRLL gives the Franklin Circuit Court broad discretion to retain full jurisdiction of the rehabilitation of AIK Comp, including any lawsuits filed by the Rehabilitator as part of the rehabilitation process; 2) the arbitration agreements do not cover all of the annual audits which the Rehabilitator alleges Ernst & Young performed negligently; 3) the Rehabilitator was not a signatory to any of the arbitration agreements; 4) the IRLL grants the Rehabilitator broad authority to exercise the state's "police powers," including the authority to revoke or rescind AIK Comp's valid arbitration agreements; and 5) the Federal Arbitration Act's preference for enforcing arbitration agreements is subordinated to the IRLL by the reverse-preemption doctrine of the McCarran-Ferguson Act, 15 U.S.C. § 1011, *et. seq.*

Ernst & Young argues that the Franklin Circuit Court order failed to recognize the supremacy of the Federal Arbitration Act and its establishment of a national policy favoring the arbitration of disputes. We do not disagree. However, we conclude that the trial court correctly found that the IRLL's broad grant of exclusive jurisdiction to the Franklin Circuit Court in matters relating to the delinquency of insurance

companies preempts and supersedes the Federal Arbitration Act and its policy favoring arbitration.

A. Reverse Preemption of the Federal Arbitration Act Under The McCarran-Ferguson Act—The *Forsyth* Test

KRS 304.33-010(6), one of the initial provisions of the IRLL, states:

> [i]f there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle. However, notwithstanding the foregoing, in any delinquency proceeding commenced against an insurer after July 15, 1996, nothing in this subtitle shall be construed to subordinate or restrict the rights of parties to submit their disputes to arbitration pursuant to a contractual arbitration clause contained in a reinsurance agreement.

"Delinquency proceeding," as defined by KRS 304.33-030(5), includes "any proceeding commenced against an insurer for the purpose of . . . rehabilitating . . . such insurer." Consequently, any provisions of the agreements between Ernst & Young and AIK Comp that conflict with KRS 304.33 "shall be subordinated to the provisions of [KRS subtitle 304.33, the IRLL]" unless as Appellants argue, the Federal Arbitration Act preempts KRS 304.33-010(6). "Under the conventional application of the supremacy clause and rules of statutory construction, the Federal Arbitration

Act, a federal statute, would preempt Kentucky's Liquidation Act, a state statute,[9] insofar as the Liquidation Act contravenes the Federal Arbitration Act." *Stephens v. American Int'l Ins. Co.*, 66 F.3d 41, 43 (2d Cir.1995). However, the McCarran-Ferguson Act, 15 U.S.C. § 1011, *et seq.*, establishes a doctrine of "reverse preemption" that expressly exempts from federal preemption state statutes enacted to regulate insurance, leaving the regulation of insurance to the individual state. Under McCarran-Ferguson, "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such [federal] Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b) (1994). The United States Supreme Court created a three-part test to determine when reverse preemption of federal law through McCarran-Ferguson occurs. The test is whether: 1) the state statute was enacted for the purpose of regulating the business of insurance; 2) the federal statute involved "does not specifically relat[e] to the business of insurance"; and 3) the application of the federal statute would "invalidate, impair, or supersede" the state statute regulating insurance. *Humana Inc. v. Forsyth*, 525 U.S. 299, 307 (1999).

In this matter, the first step of the *Forsyth* test is clearly satisfied. There can be no reasonable doubt that the IRLL, of which KRS 304.33-010(6) is a part, was enacted to regulate the "business of insurance." *Stephens*, 66 F.3d at 41; *National Home Ins. Co. v.*

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[9] The Court in *Stephens* adopted the term "the Kentucky Liquidation Act" as a shorthand reference for the Kentucky Insurers Rehabilitation and Liquidation Law, KRS 304.33-010 *et seq. Stephens*, 66 F.3d at 42.

King, 291 F.Supp.2d 518 (E.D. Ky. 2003). We can hardly overstate the degree to which the regulation of insurance permeates this controversy. The very claims which Ernst & Young would take to arbitration arise directly out of Kentucky's intense interest in the regulation of worker's compensation insurance. The audits that form the core of the Rehabilitator's claims were performed by Ernst & Young for AIK Comp to comply with state insurance regulations which include a review of such audits by the state's insurance commissioner to monitor the solvency of AIK Comp. The IRLL is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company.

The second step of the *Forsyth* test is satisfied because the Federal Arbitration Act does not "specifically relat[e] to the business of insurance." *See Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585, 590 (5th Cir. 1998); *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1279 (10th Cir. 1998).

The third step of the *Forsyth* test presents the question of whether the application of a federal law, in this case the Federal Arbitration Act, would "invalidate, impair, or supersede" provisions of a state statute regulating insurance, the IRLL. In essence, this returns us to KRS 304.33-010(6) because the question of whether the Federal Arbitration Act (with its strong preference for arbitration) "invalidates, impairs, or supersedes" a state law regulating insurance is, as a practical matter, virtually the same question we started with: whether the arbitration clauses of the engagement letters conflict with any provisions of the IRLL. If, as the Rehabilitator argues,

arbitration is inconsistent with parts of the IRLL, then KRS 304.33-010(6) commands that the arbitration clauses be overridden, and for that same reason, the final part of the *Forsyth* test would be satisfied.

B. The Arbitration Clauses and the FAA Conflict with the IRLL's Grant of Broad Exclusive Jurisdiction to the Franklin Circuit Court

Enforcement of the arbitration clauses found in the engagement letters between Ernst & Young and AIK Comp conflicts with the IRLL. We are directed by KRS 304.33-010(3) to liberally construe the provisions of the IRLL to effect the purposes stated in KRS 304.33-010(4). KRS 304.33-010(4)(c) expressly states that one of the purposes of the IRLL is the "enhanced efficiency and economy of liquidation, through the *consolidation of matters relating to the liquidation under the supervision of a single court* so as to avoid divergent rulings by a multiplicity of judicial tribunals . . . ." (emphasis added). KRS 304.33-040(3)(a) provides that "the [Franklin Circuit] court[10] shall have exclusive jurisdiction to entertain, hear, or determine all matters in any way relating to any delinquency proceeding under this subtitle, including, but not limited to, all disputes involving purported assets of the insurer." KRS 304.33-040(3)(b) allows the Franklin Circuit Court to "authorize a rehabilitator[11] to seek injunctive

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[10] The actual word used in KRS 304.33-040 is "court." However, KRS 304.33-030 defines court as the "Franklin Circuit Court."

[11] The statute uses the word "receiver" which at KRS 304.33-030(3) is defined to include a "receiver, liquidator, rehabilitator, or conservator, as the context requires."

or other appropriate relief from other courts, either within this state or without this state, if in the opinion of the [Franklin Circuit] court, this action will be an aid to any delinquency proceeding."

Similarly, KRS 304.33-140(2) provides:

> (2) Upon the issuance of an order directing the executive director to rehabilitate a domestic insurer, the [Franklin Circuit] court shall have exclusive jurisdiction over all matters relating to the rehabilitation, including, but not limited to, the proper scope and application of the provisions of this subtitle to the rehabilitation as well as all interpretation and enforceability of all contracts of insurance to which the insurer is a party.

Exclusive jurisdiction over "*all matters in any way relating to* any delinquency proceeding . . . including . . . all disputes involving purported assets of the insurer"[12] and over "*all matters relating to* the rehabilitation"[13] is an extremely broad grant of authority by the General Assembly to the Franklin Circuit Court. Such broadly defined exclusive jurisdiction, coupled with directions for liberal construction, is a very rare, if not unique, provision in Kentucky law. We have on other occasions in another context noted the broad scope of this jurisdictional grant:

> The subtitle provides Franklin Circuit Court broad discretion as to supervision of the proceedings. KRS 304.33-040 pertains to the

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[12] KRS 304.33-040(3)(a).

[13] KRS 304.33-140(2).

> exclusiveness of proceedings and states that the court shall have exclusive jurisdiction over all matters relating to the proceeding, including all disputes over assets. The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the subtitle. Section (3)(c) states that no provisions in the subtitle shall be construed to preclude the court from, on its own motion, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules or to prevent an abuse of process.

Kentucky Central Life Ins. Co. v. Stephens, 897 S.W.2d 583, 587 (Ky. 1995); *see also Minor v. Stephens*, 898 S.W.2d 71, 80 (Ky. 1995).

It is evident that an essential goal of the IRLL is to promote consistent rulings in all matters that impact the rehabilitation of an insurance company. We believe that the strong language of KRS 304.33-040(3)(a) and KRS 304.33-140(2) is an unambiguous expression of the General Assembly's intention to achieve that goal by concentrating in the Franklin Circuit Court "all matters in any way related" to the proceeding to rehabilitate or liquidate an insurance company. The vesting of such jurisdiction in the Franklin Circuit Court, including the broad authority to supervise all issues relating to a rehabilitation, provides a logical and reasonable means of attaining the IRLL's stated purpose of achieving "enhanced efficiency and economy of liquidation, through the consolidation of matters relating to the liquidation under the supervision of a single court so as to avoid divergent rulings by a multiplicity of judicial tribunals." KRS 304.33-010(4)(c)).

Compelling the enforcement of the arbitration agreements in this case would remove virtually all of the supervisory authority of the Franklin Circuit Court over the adjudication of the Rehabilitator's claims against Ernst & Young and place it in the hands of the arbitrators. Thus, all discovery issues, evidentiary disputes, and determinations of applicable law would be made by the arbitrators, not by the court as the General Assembly intended.

Inconsistent and incompatible results are possible if the Rehabilitator's claims against Ernst & Young are resolved by arbitration, while other issues pertaining to the AIK Comp rehabilitation are adjudicated in the Franklin Circuit Court. Piecemeal adjudication and the potential for inconsistent verdicts are what the General Assembly sought to avoid by the IRLL's strong grant of exclusive jurisdiction to the Franklin Circuit Court.

Ernst & Young argues that the potential for such inefficiencies is not relevant to the enforceability of valid arbitration agreements, and cites cases that discount such concerns in favor of arbitration.[14] We recognize the validity of the cited authority, but we note that they do not involve arbitration in the context of a proceeding to liquidate or rehabilitate an insurance company, with the extraordinary state interest vested therein; nor, do they involve the strong statutory preference for the resolution of such matters in a specific forum that we find in the IRLL.

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[14] *Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213 (1985); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.,* 460 U.S. 1 (1983).

Ernst & Young also argues KRS 304.33-010(6) does not apply in this case because the Rehabilitator's lawsuit is not a "delinquency proceeding." *See Nichols v. Vesta Fire Ins. Corp.*, 56 F.Supp.2d 778 (E.D. Ky. 1999) (holding that an insurance Rehabilitator's breach of contract suit filed against a third-party insurer was merely a "garden variety" lawsuit, not a delinquency proceeding in which KRS 304.33-010(6) would apply). On this point, we first note that KRS 304.33-010(6)'s subordination of contractual provisions that conflict with the IRLL is not limited to the "delinquency proceeding." By the plain language of KRS 304.33-010(6), any contractual provision in conflict with the IRLL is subordinated "*[i]f there is a delinquency proceeding under this subtitle . . .*" (emphasis added). That there is, in fact, a delinquency proceeding in the Franklin Circuit Court regarding AIK Comp cannot be disputed, and as part of that proceeding under KRS 304.33-160(4), the Rehabilitator has been charged to "pursue all appropriate legal remedies on behalf of the insurer."

Secondly, the federal court in *Nichols* found that the exclusive jurisdiction granted by KRS 304.33-040 to the Franklin Circuit Court was inapplicable because the claim involved was simply a "common law breach of contract action which merely happens to involve an insolvent insurer." *Nichols*, 56 F.Supp.2d. at 780. "[T]he instant action is no more than a garden variety contract suit which happens to involve two insurers. The fact that one is insolvent is irrelevant[.]" *Id.* at 781. Far from being just a coincidental aspect of a "garden variety" claim, AIK Comp's insolvency was allegedly caused by Ernst & Young's audits which masked AIK Comp's true financial condition. Under the Reorganization Plan approved by the Franklin

Circuit Court, the Rehabilitator's claims against Ernst & Young are an essential component of AIK Comp's rehabilitation. Unlike the claims in *Nichols*, the claims asserted by the Rehabilitator fall squarely within the scope of KRS 304.33-040(3)(a), as "matters . . . relating to [a] delinquency proceeding under this subtitle, including . . . all disputes involving purported assets of the insurer," and therefore, under KRS 304.33-010(6) remain within the exclusive jurisdiction of the Franklin Circuit Court.

We therefore conclude that the contractual provisions for arbitration under the Federal Arbitration Act are in conflict with the jurisdictional requirements of the IRLL. In reaching this conclusion, we reject Ernst & Young's comparison of that result to the anti-arbitration concept of "ouster of jurisdiction," a doctrine discredited in *Fite & Warmath Construction Co. v. MYS Corp.*, 559 S.W.2d 729, 735 (Ky. 1977), and *Kodak Min. Co. v. Carrs Fork Corp.*, 669 S.W.2d 917, 921 (Ky. 1984). We recognize that when a lawsuit is submitted to arbitration, the trial court technically retains jurisdiction over the proceeding while the issues are arbitrated. But, we also recognize that in such situations, the trial court no longer retains the authority to "determine all matters in any way related to the delinquency." KRS 304.33-040(3)(a). When a dispute goes to arbitration, the trial court's broad discretion to decide all issues pertaining to pre-hearing procedures, including discovery, all issues of substantive law, and all evidentiary matters passes to the arbitrator. 4 Am. Jur. 2d. *Alternative Dispute Resolution*, § 157-169 (2007). The trial court's function is constricted to the simple entry of a final judgment enforcing the arbitrator's decision. *See DiMercurio v. Sphere Drake, Ins., PLC*, 202 F.3d 71, 77 (1st Cir.

2000) (holding that "arbitration agreements do not divest courts of jurisdiction, though they prevent courts from resolving the merits of arbitrable disputes.") Only if the arbitrator's decision is alleged to have been tainted by fraud or favoritism does the trial court have the ability to intercede. *See Wall Street Associates, L.P. v. Becker Paribas Inc.*, 27 F.3d 845, 849 (2d Cir. 1994)(citing the Federal Arbitration Act, 9 U.S.C. § 10); *3D Enterprises Contracting Corp. v. Lexington-Fayette Urban County Government*, 134 S.W.3d 558, 561 (Ky. 2004) (citing KRS 417.160 of Kentucky's Uniform Arbitration Act). Such a substantial reduction of the court's role in a process central to the rehabilitation of an insurance company is inconsistent with our legislature's extensive grant of exclusive jurisdiction to the Franklin Circuit Court. The General Assembly did not intend for that grant of jurisdiction to be overruled by an insurance company's agreement to arbitrate issues critical to the state's interest in the rehabilitation or liquidation of the insurance company.

Therefore, we conclude that the third part of the *Forsyth* test is satisfied because the Federal Arbitration Act's preference for arbitration conflicts with, and impairs, the IRLL's grant of broad and exclusive jurisdiction to the Franklin Circuit Court. In this case, application of the McCarran-Ferguson Act reverse-preempts the Federal Arbitration Act. Pursuant to KRS 304.33-010(6), the federal policy favoring arbitration is subordinated to the state's superior interest in having matters relating to the rehabilitation of an insurance company adjudicated in the Franklin Circuit Court.

The Rehabilitator properly chose to initiate her claims against Ernst & Young in the Franklin Circuit

Court, and properly declined to submit the matter to arbitration. We affirm the court's order denying Ernst & Young's motion to compel arbitration of the Rehabilitator's claims.

III. THE CLASS ACTION PLAINTIFFS ARE BOUND BY THE ARBITRATION CLAUSES IN THE ENGAGEMENT LETTERS

Ernst & Young next argues that the Franklin Circuit Court erred by denying its motion to compel arbitration of the members' class action lawsuit. The Franklin Circuit Court denied the motion for the following reasons: 1) the court believed the plaintiffs' claims against Ernst & Young were not covered by the arbitration clauses because they do not "arise out of or relate to" the services Ernst & Young performed pursuant to the engagement letters; 2) the class action plaintiffs had not signed the engagement letters containing the arbitration agreements, are not identified in the agreements as parties subject to the arbitration clauses, and are not otherwise bound under agency principles to the arbitration clauses; 3) the plaintiffs are not third-party beneficiaries to the engagement letters containing arbitration agreements; 4) the plaintiffs are not equitably estopped from disavowing the arbitration clauses; and 5) compelling arbitration of class action claims while the Rehabilitator's claims are litigated promotes the inefficiencies and confusion inherent in piecemeal adjudication.

We begin the analysis with the trial court's first reason and fifth reason as listed above because if either of those reasons validly supports its decision, our

consideration of the remaining issues becomes unnecessary.

A. The Plaintiffs' Claims Arise From the Services Ernst & Young Performed Pursuant to the Engagement Letters

The trial court justified its refusal to enforce the arbitration clauses in the engagement letters by holding that the clauses simply do not apply to the class action claims in question. We disagree. The arbitration clauses plainly state that they apply to "[a]ny controversy or claim arising out of or relating to services covered by this letter . . . ," the services being Ernst & Young's accounting and auditing for AIK Comp. Regardless of whether the class action claims are viewed as contract disputes or tort claims, or as something else, Ernst & Young's auditing and accounting services for AIK Comp are the basis for all of the claims. Thus, the plaintiffs' claims "arise out of" and "relate to" the services Ernst & Young were obligated by the engagement letters to render.

B. Inefficient Piecemeal Adjudication of Complex Litigation Does Not Authorize Avoidance of Agreements to Arbitrate

The trial court concluded that despite any basis upon which the class action plaintiffs might otherwise be bound by the arbitration clauses, arbitration of their claims should not be compelled because resolving the class action claims in a forum separate and apart from the adjudication of the Rehabilitator's claims unduly complicates an already complex matter, infusing it with the inefficiency of duplicative effort and the potential for inconsistent or incompatible results. Having previously noted that the claims of the

Rehabilitator and the claims of the class action plaintiffs are based upon the same allegations of deficient auditing by Ernst & Young, we do not doubt that separate adjudicative processes will substantially increase the burden in time and expense to witnesses and litigants.

However, as we also stated previously in this opinion, the Rehabilitator's claims involve the rehabilitation of an insurance company which is a matter of such compelling state interest that, under federal law, it transcends the applicability of the Federal Arbitration Act. Although the class action plaintiffs' claims and the Rehabilitator's claims arise from the same course of conduct, the class action claims are essentially private disputes with no substantial impact on the state's regulation of insurance. Joining the claims of the class action plaintiffs with the Rehabilitator's claims may promote judicial economy, but we do not see that it would promote the legislative policy embodied in KRS 304.33-010(4) for consolidating the various claims of the Rehabilitator. Without an overarching state interest to the contrary, the class action plaintiffs cannot avoid the forceful preference for arbitration found in the Federal Arbitration Act. The United States Supreme Court has decided the question in favor of the Federal Arbitration Act's national policy promoting arbitration. *See Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213, 217 (1985) (holding the Federal Arbitration Act requires arbitration of pendent arbitrable claims even where the result would be the inefficient maintenance of separate proceedings in different forums); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.,* 460 U.S. 1, 20 (1983) (holding that under the Federal Arbitration Act, an arbitration agreement

must be enforced even though it results in piecemeal litigation by other persons who are parties to the underlying dispute but not to the arbitration agreement.) We perceive that the federal policy allows no accommodation for the situation present here. Thus we conclude that the trial court erred by finding that arbitration could be denied on the grounds of judicial economy.

C. The Class Action Plaintiffs Gave Assent to the Arbitration Clause via their Application for AIK Comp Membership

None of the class action plaintiffs actually signed the engagement letters. However, Ernst & Young argues that each of the class action plaintiffs is nevertheless bound to the arbitration agreements because upon joining AIK Comp, each executed a membership application giving assent to be bound by AIK Comp's contracts. The argument, although presented by Ernst & Young to the trial court, is not mentioned in the order denying the motion to arbitrate. However, we agree that the assent given in the membership application binds the class action plaintiffs to the arbitration clauses.

In the membership application, each class action plaintiff upon joining AIK Comp agreed to "appoint AIK Comp and its trustees to act as [its] agent[s] in all matters relating to Kentucky Workers' Compensation Statutes" and "to abide by the rules, regulations and by-laws of [AIK Comp] and *to conform to the terms of the agreements they may enter into with any authorized service company* " for as long as membership in AIK Comp was maintained. (emphasis added.) Ernst & Young reasons that since AIK Comp's annual audits

are matters "relating to Kentucky Workers' Compensation Statutes," Maurice Turner[15] acted as an agent of each member when he executed the engagement letters.

First, we do not agree with Ernst & Young's argument that AIK Comp acted as the agent of its members when it executed the engagement letters. Under basic agency principles, an agent acts on the principal's behalf and is subject to the principal's control. *See Restatement (Third) Of Agency § 1.01* (2006). The audit requirement of KRS 342.347(2)[16] pertains only to AIK Comp. AIK procured the audits for itself, not as an agent on behalf of the individual members. As employers, the members are bound by Kentucky's workers' compensation laws, but they have no duty to obtain an audit and therefore have no need of an agent in obtaining one. In signing the engagement letters, Turner was not acting as an agent of the class action plaintiffs. We construe that language of the membership application as simply enabling AIK Comp to act as agent for the individual members in the processing and settlement of worker compensation claims, just as traditional workers' compensation insurers act as agents of the parties they insure to resolve workers' compensation issues.

Ernst & Young's second argument, that the member application compels each member of AIK Comp "to conform to the terms of the agreements [AIK Comp] may enter into with any authorized service company," is well taken. We are presented with no sound rationale by which we may conclude otherwise.

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[15] Chief Executive Officer of AIK Comp.

[16] Now KRS 304.50-110.

The plaintiffs do not contend that Ernst & Young is not an "authorized service company." By accepting membership in AIK Comp, the class action plaintiffs agreed to "conform" to AIK Comp's agreements. We find no basis upon which to distinguish the arbitration clauses of the engagement letters from any other agreement with a service company, and thus conclude each class action plaintiff, under the terms of the membership application, agreed to "conform" to AIK Comp's agreements with Ernst & Young, including the agreement that claims or controversies arising from Ernst & Young's services be submitted to arbitration.

Accordingly, we reverse the trial court's order denying Ernst & Young's motion to compel arbitration of the class action claims. Because of that resolution, we need not address Ernst & Young's argument that the class action plaintiffs are third-party beneficiaries under the agreements and are otherwise equitably estopped from disavowing the agreements.

D. The Other Entities Listed in the Arbitration Clauses are not Bound Thereby

The class action plaintiffs argue that the 2002 modification to the engagement letter, which purports to add "any person or entity for whose benefit the services in question are or were provided" to the list of parties required to arbitrate, is a clear indication that they were excluded from the arbitration clauses in the 1998-2001 engagement letters. We are not persuaded however, because we do not read the agreements as establishing a list of collateral parties to be bound thereby. The list of other entities in the arbitration clauses does not purport to identify the parties that

must submit to arbitration. Literally read, it simply includes as among the kinds of disputes that AIK Comp must arbitrate, controversies that "involve" the listed entities. The listing of such entities is of no significance in the resolution of the issues presented herein, and the 2002 modification provides no relief to the class action plaintiffs.

IV. CONCLUSION

For the reasons set forth above, we affirm the Franklin Circuit Court's order in Civil Action No. 05-CI-00344 denying the Appellants' demand for arbitration of the claims brought against it by the AIK Comp Rehabilitator, and we reverse the Franklin Circuit Court's order in Civil Action No. 05-CI-00455 denying the Appellants' motion to compel arbitration of the claims of Appalachian Regional Healthcare, Inc. and the other class action plaintiffs. Accordingly, we remand this matter to the Franklin Circuit Court for entry of an order compelling arbitration of the class action lawsuit and for further proceedings in the adjudication of the Rehabilitator's claims.

All sitting. All concur.

SUPREME COURT OF KENTUCKY

No. 2007-SC-000770-T

Court of Appeals
No. 2007-CA-002050
Franklin Circuit Court No. 05-CI-00455

ERNST & YOUNG LLP, ET AL.

Appellants

v.

JULIE MIX McPEAK (EXECUTIVE DIRECTOR, KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP), ET AL.

Appellees

Order Granting Transfer & Consolidation

The motion to transfer this appeal from the Court of Appeals to the Supreme Court is hereby GRANTED and this case is hereby consolidated with *Ernst & Young v. Appalachian Regional Healthcare, et al.*, 2007-SC-000936-T.

The Clerk of the Court of Appeals is directed to forthwith transfer to this Court all of the records and files on appeal.

The parties shall comply with the briefing schedule as specified in CR 76.12. This case shall be subsequently set for oral argument.

All sitting. All concur.

ENTERED: April 24, 2008.

CHIEF JUSTICE
JOSEPH E. LAMBERT

Entered: Sept. 13, 2007

COMMONWEALTH OF KENTUCKY
Franklin Circuit Court
Division No. II

Civil Action No. 05-CI-455

JULIE MIX McPEAK (EXECUTIVE DIRECTOR, KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP),

Plaintiff

v.

ERNST & YOUNG LLP,

Defendants

Opinion & Order

This matter is before the Court upon Defendants, Ernst & Young, LLP's ("E&Y") motion for an Order staying this action and compelling arbitration. The Court having considered the record, having heard the arguments of counsel, and being otherwise sufficiently advised, issues the following Opinion and Order:

Facts

E&Y provided auditing services to AIR Comp, f/k/a Associated Industries of Kentucky Selective Self-Insurance Fund ("AIK") from 1998 to 2003. E&Y asserts that it entered into a contract with AIK to

provide auditing services for the years 2001 - 2003 which contained a prescribed dispute resolution agreement, E&Y contend this dispute resolution agreement requires AIK (and in return Julie Mix McPeak, Executive Director, Kentucky Office of Insurance, as Rehabilitator ("Rehabilitator")) to participate in a mediation and then a final and binding arbitration.

As the result of a dispute between AIK and E&Y in 2003, E&Y discontinued its provision of auditing services to AIK. This dispute was not submitted to arbitration.

On March 29, 2005, the Rehabilitator filed suit against E&Y, David S. Meyer, Stephen P. Lattanzio, and Actuarial & Technical Solutions, Inc. pursuant to this Court's order that AIK be placed in Rehabilitation and KRS 304.33 et. seq. ("the Kentucky Insurance Code"). The Rehabilitator's allegations against E&Y include counts of negligence, negligent misrepresentation and violations of the Kentucky Insurance Code (preparing, filing with AIK's regulators and providing to the AIK group members deceptive, unfair and misleading financial statements which misrepresented the true financial condition of AIK). The Rehabilitator claims this pattern of conduct began in 1998 when E&Y began providing auditing services and continued in each year up to and including 2003.

The Rehabilitator has also filed suit against AIK Inc. and former officers and trustees of AIK. The Rehabilitator's allegations against those parties include counts of negligence, negligent misrepresentation, breach of fiduciary duties and unjust enrichment.

E&Y filed a Motion for Order Staying this Action and Compelling Arbitration. E&Y argues that the Rehabilitator's claims are subject to an enforceable, written agreement, and that this Court should stay all claims against E&Y pending the arbitration of those claims.

The Rehabilitator contends this argument is flawed for many reasons. The Rehabilitator claims that E&Y alleged breach of the contract in 2003 and failure to pursue arbitration voided any enforceable arbitration agreement against AIK. In addition, the Rehabilitator claims that any agreement which could be enforceable against AIK compelling arbitration may not be applied to additional years (i.e., E&Y claim that the agreement to arbitrate covers years 2001, 2002 and 2003, but a dispute exists as to years 1998 - 2003). The Rehabilitator also claims that she may not be called upon to answer for AIK in relation to arbitration agreements because she was not a signatory and she does not "stand in the shoes" of the former AIK as E&Y contend. Last but not least, the Rehabilitator claims that as a result of the Commonwealth's police power and the statutory grant of power within the Kentucky Insurance Code, she may revoke or rescind any existing and valid arbitration agreements entered into by AIK prior to its placement in rehabilitation in order to further a compelling public and governmental interest. This Court agrees.

Discussion

1. This Court has the Discretion to Retain Full Jurisdiction of the Rehabilitation Action Pursuant to KRS 304.33-040.

The Kentucky Insurance Code (US 304.33 *et seq.)* regulates the performance of an insurer's contracts once an insurer or self-insurance group is placed into rehabilitation. The Kentucky Insurance Code provides the Franklin Circuit Court "broad discretion" as to supervision of the rehabilitation of AIK Comp. Specifically, KRS 304.33-040 clearly states that the Court shall have exclusive jurisdiction over all matters relating to the rehabilitation of AIK Comp. *See Minor v. Stephens,* 898 S.W.2d 71, 78 (Ky. 1995); *see also* KRS 304.33-040. KRS 304.33-010(6)[1] makes it clear that the Kentucky insurance Code exclusively governs the rehabilitation of AIK. The statute renders arbitration clauses unenforceable during rehabilitation because such clauses take control over important aspects of the rehabilitation away from this Court and take important proceedings outside of the Kentucky Insurance Code.

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[1] If there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle however, notwithstanding the foregoing, in any delinquency proceeding commenced against an insurer after July 15, 1996, nothing in this subtitle shall be construed to subordinate or restrict the rights of parties to submit their disputes to arbitration pursuant to a contractual arbitration clause contained in a reinsurance agreement.

KRS 304.33-040(3)(b) provides that "the court may authorize the receiver to seek injunctive or other appropriate relief from other courts, either within or without of state, if, *in the opinion of the court, this action will be an aid to any delinquency proceedings.*" (emphasis added). The Kentucky Insurance Code instructs this Court that traditional notions of *forum non conveniens* is an appropriate reason for the removal of the delinquency proceeding and/or ancillary matters from before this court.

The third party cause of action against E&Y is clearly a significant aspect of the rehabilitation of AIK Comp. AIK Comp is currently facing an enormous financial deficit that must be remedied. This Court can find no reason or explanation to support E&Y's claim that it would be an aid to any delinquency proceedings to stay this matter and submit it to an arbitration order. Arbitration between AIK Comp and E&Y contemplates the very real risk of disparity of judgments resulting from the arbitration and a trial before this Court regarding the remaining defendants.

It is difficult to imagine the confusion and inefficiencies that are certain to arise should the Court retain jurisdiction over all third party causes of action except those where against E&Y. The allegations against this Defendant are closely related to the allegations against David S. Meyer, Stephen P. Lattanzio, Actuarial & Technical Solutions, Inc., former officers and trustees of AIK and AIK, Inc. The same discovery that will be necessary and relevant to E&Y will also be relevant to the other third party defendants, including the same documents and the same witnesses. It makes very little sense to have the Rehabilitator involved in various and differing dispute

resolution proceedings when the claims against the third parties are all directly related.

The salutary purposes of state insurance rehabilitations, of treating all involved fairly, would be circumvented if E&Y is allowed to have its disputes with AIK adjudicated in a manner inconsistent with others. If the Rehabilitator is embroiled in piecemeal litigation and dispute resolution, legal expenses increase dramatically and the estate decreasingly correspondingly.

By retaining exclusive jurisdiction over this matter, the Court will also ensure that the Court can continue its close scrutiny of all aspects of the rehabilitation. It is well within the discretion of both the Rehabilitator and this Court for the Court to retain jurisdiction over the third party actions against E&Y, even though it may interfere with the contractual relations of private parties.

2. Any Enforceable Agreement Against AIK Compelling Arbitration May Not Be Applied To Additional Years

E&Y provided AIK auditing services from 1998 to 2003. The arbitration agreement which E&Y attempt to enforce was applicable only to the years 2001, 2002 and 2003. The Rehabilitator has filed suit against E&Y for its negligence in performing auditing services for AIK for the years ending 1998, 1999, 2000, 2001 and 2002 (E&Y withdrew its engagement with AIK in 2003). Thus the arbitration agreement is completely irrelevant and unenforceable as to any cause of action or dispute that arose between the parties in 1998, 1999 and 2000.

The allegations and counts of negligence, negligent misrepresentation and various statutory violations against E&Y arise from E&Y's work throughout its entire relationship with AIK and cannot be separated.

In *Sec. Watch, Inc. v Sentinel Sys., Inc.*, 176 F.3d 369, 372 (6th Cir. 1999), the Sixth Circuit Court of Appeals held that an arbitration agreement cannot be used to compel arbitration of disputes that arise under prior agreements that do not contain arbitration provisions. If this Court were to enforce the alleged arbitration agreement, it could only do so for the years 2001, 2002 and 2003. This would mean that the disputes regarding these years would be determined by an arbitration and the disputes regarding the years 1998, 1999 and 2000 would be determined by this Court. It would benefit no one for this Court to require the Rehabilitator to prosecute its case against E&Y in two separate dispute resolution forums.

3. The Rehabilitator is Not a Signatory to Any Arbitration Agreement Between AIK and E&Y.

The Rehabilitator is not a party to any agreement to arbitrate. The Rehabilitator did not sign or agree to the arbitration. E&Y seeks to impose that duty because the Rehabilitator assumed the powers of the officers and trustees of AIK. There exist no facts which support commonly recognized reasons for applying a contractual agreement to a nonsignatory.

A party to an arbitration agreement may compel arbitration against a nonsignatory to that arbitration agreement when that party has entered into a separate contractual relationship with the nonsignatory which incorporates the existing arbitration clause. *See*

Import Export Steel Corp. v. Mississippi Valley Barge Line Co., 351 F.2d 503, 505-06 (2d Cir. 1965). There is no evidence to indicate that the Rehabilitator has entered into any separate contractual relationship with E&Y.

In the absence of a signature, a party may be bound by an arbitration clause if its subsequent conduct indicates that it is assuming the obligation to arbitrate. *In re Transrol Navegacao S.A.*, 782 F.Supp. 848, 851 (S.D.N.Y. 1991). The Rehabilitator has done nothing to indicate that she is assuming any obligation to arbitrate this dispute with E&Y.

Traditional principals of agency law may bind a nonsignatory to an arbitration agreement. *See Interbras Cayman* Co. *v. Orient Victory Shipping Co., S.A.*, 663 F.2d 4, 6-7 (2nd Cir. 1981). Because the arbitration agreement was entered into well before the rehabilitation of AIK, the Rehabilitator cannot possibly be bound under an agency theory.

Some courts have recognized an alternative estoppel theory requiring arbitration between a signatory and nonsignatory. *See Sunkist Soft Drinks, Inc. v. Sunkist Growers, Inc.*, I0 F.3d 753, 757 - 58 (11th Cir. 1993). At no point and under no circumstances has the Rehabilitator indicated a willingness to arbitrate. As such, the Rehabilitator cannot be bound by the arbitration agreement under an estoppel theory.

4. The Rehabilitator May Revoke or Rescind Any Existing and Valid Arbitration Agreement Entered into by AIK.

Pursuant to KRS Chapter 304, Subtitle 33 (the "Kentucky Insurance Code"), the Rehabilitator dearly has the exclusive authority to bring civil actions on behalf of AIK Comp against "any officer, manager, agent, employee, or other person" whom the rehabilitator has reason to belief engaged in "tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer [AIK Comp]." KRS 304.33-160(4).

The Rehabilitator derives her power to rehabilitate AIK Comp pursuant to KRS 304.33 ("the Kentucky Insurance Code"). This grant is a statutory embodiment of the police powers of the Commonwealth. *See Minor,* 898 S.W.2d at 78 (Ky. 1995) (specifically holding that the authority to rehabilitate an insurer is an aspect of the police powers of the Commonwealth).

The successful rehabilitation of AIK is clearly an important public matter. The Rehabilitator, with supervision from this Court, is taking steps in furtherance of that public interest. "The due process clause does not restrict the state's reasonable exercise of its police power in furtherance of the public interest, even though such laws may interfere with contractual relations and commercial freedoms of private parties." *Minor v. Stephens*, 898 S.W.2d 78, 82 (Ky. 1995). Additionally, the private contracts of those with an interest in the insurer or self-insurance group are "subject to a reasonable exercise of state police

powers." *Kentucky Central Life Ins. Co. v. Stephens*, 897 S.W.2d 583, 587 (Ky. 1995).

In this case, E&Y is attempting to enforce a private contract it had with AIK against the Rehabilitator. KRS 304.33-010(6) specifically subordinates that agreement to this proceeding. In rehabilitating AIK, however, the Rehabilitator is making use of the police powers expressly granted to her by the Commonwealth and this Court, and, as the Kentucky Supreme Court has squarely held, the reasonable exercise of a state's police powers in furtherance of the public interest does not violate the due process rights of any party that may be affected by that exercise. The Rehabilitator, having considered the available options, strongly believes that having this Court retain exclusive jurisdiction over the rehabilitation proceedings, including all third party causes of action, will best serve the public interest in ensuring a successful and efficient rehabilitation of AIK.

5. Federal Law Does Not Preempt State Law.

Generally, arbitration clauses are enforceable under the Federal Arbitration Act ("FAA"). 9 U.S.C. § 3 (1994). However, the McCarran-Ferguson Act ("McCarran-Ferguson"), 15 U.S.C. § 1011 *et seq.*, preserves state statutes enacted "for the purpose of regulating the business of insurance" from preemption and leaves the regulation of the business of insurance to the states. Under McCarran-Ferguson, "[n]o Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance...unless such Act specifically relates to the business of

insurance." 15 U.S.C. § 1012(b) (1994). The McCarran-Ferguson Act establishes an "express federal policy of noninterference in insurance matters" and a clear" [congressional mandate] that regulation of the insurance industry be left to the individual states." *Levy v. Lewis*, 635 F.2d 960, 963 - 964 (2d Cir. 1980).

Because the Kentucky Insurance Code is a state statute enacted "for the purpose of regulating the business of insurance" and is "designed to protect policyholders", McCarran-Ferguson expressly exempts it from preemption by the FAA. Accordingly, the FAA and federal case law interpreting that act, is irrelevant to this action.

Conclusion

There have been very convincing arguments made by the Rehabilitator that the arbitration agreement between AIK and E&Y is not valid and has been voided by the conduct of the parties. Be that as it may, it is very clear to this Court that enforcing any arbitration agreement between an insurer and a third party upon a Rehabilitator will certainly lead to a less organized and unpredictable reorganization pursuant to the Kentucky Insurance Code. The Rehabilitator will be forced into piecemeal litigation in an effort to prosecute actions against those who are responsible for the insurer's financial distress. Such a result is certainly not what the General Assembly intended when it enacted the Kentucky Insurance Code.

Kentucky has enacted comprehensive statutes and rules to regulate the business of insurance, including the rehabilitation of insurance companies and self-insurance groups. Under the Kentucky Insurance Code, the Rehabilitator is vested with title to the

property and contracts of AIK for the benefit of AIK group members, and most importantly for the benefit of injured workers in the Commonwealth who are dependent upon the successful rehabilitation of AIK for the benefits owed to them. The Rehabilitator, which supervision from this Court, is also authorized to exercise exclusive jurisdiction over the rehabilitation estate of AIK.

So ORDERED This 12 day of September, 2007.

Thomas D. Wingate, Judge
Franklin Circuit Division
Division No. II

U.S. Const., Art. VI, cl. 2.

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Ky. Rev. Stat. Ann. § 304.33-010 — Title, construction, and purpose

(1) Short title. This subtitle may be cited as the "Insurers Rehabilitation and Liquidation Law."

(2) Construction. No limitation of powers. This subtitle shall not be interpreted to limit the powers granted the commissioner by other provisions of the law.

(3) Liberal construction. This subtitle shall be liberally construed to effect the purpose stated in subsection (4) of this section.

(4) Purpose. The purpose of this subtitle is the protection of the interests of insureds, creditors, and the public generally, with minimum interference with the normal prerogative of proprietors, through:

(a) Early detection of any potentially dangerous condition in an insurer, and prompt application of appropriate corrective measures, neither unduly harsh nor subject to the kind of publicity that would needlessly damage or destroy the insurer;

(b) Improved methods for rehabilitating insurers, by enlisting the advice and management expertise of the insurance industry;

(c) Enhanced efficiency and economy of liquidation, through the consolidation of matters relating to the liquidation under the supervision of a single court so as to avoid divergent rulings by a multiplicity of judicial

tribunals and through clarification and specification of the law, to minimize legal uncertainty and litigation;

(d) Equitable apportionment of any unavoidable loss;

(e) Lessening the problems of interstate rehabilitation and liquidation by facilitating cooperation between states in the liquidation process, and by extension of the scope of personal jurisdiction over debtors of the insurer outside this state;

(f) Regulation of the insurance business by the impact of the law relating to delinquency procedures and substantive rules on the entire insurance business; and

(g) Provision for a comprehensive scheme for the supervision, rehabilitation, and liquidation of insurance companies and those subject to this subtitle as part of the regulation of the business of insurance, insurance industry, and insurers in this state. Proceedings in cases of insurer insolvency and delinquency shall be deemed an integral aspect of the business of insurance and are of vital public interest and concern.

(5) All persons who voluntarily transact business with an insurer which is subsequently the subject of a delinquency proceeding under this subtitle shall be conclusively presumed to have transacted business with the intent that the provisions of this subtitle would control if there is any delinquency proceeding in this state.

(6) If there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle. However, notwithstanding the foregoing, in any delinquency proceeding commenced against an insurer after July 15, 1996, nothing in this subtitle shall be construed to subordinate or restrict the rights of parties to submit their disputes to arbitration pursuant to a contractual arbitration clause contained in a reinsurance agreement.

Ky. Rev. Stat. Ann. § 304.33-030 — Definitions.

For the purposes of this subtitle:

(1) "Agent" means all persons who have collected or are holding premiums or other assets of the insurer, including but not limited to brokers, intermediaries, managing general agents, underwriting managers, and reinsurance managers, and any other persons who have entered into a fiduciary relationship with the insurer subject to delinquency proceedings, including but not limited to persons holding licenses under Subtitles 9, 32, 38, and 43 of KRS Chapter 304;

(2) "Commissioner" means the commissioner of the Department of Insurance of this state;

(3) "Receiver" means receiver, liquidator, rehabilitator, or conservator, as the context requires;

(4) "Insurer" has the meaning defined in Subtitle 1 of this chapter. For purposes of this subtitle, all other persons included under KRS 304.33-020 shall be deemed to be insurers;

(5) "Delinquency proceeding" means any proceeding commenced against an insurer for the purpose of liquidating, rehabilitating, reorganizing, or conserving such insurer, and any summary proceeding under KRS 304.33-110 to 304.33-130, inclusive;

(6) "State" has the meaning defined in Subtitle 1 of this chapter;

(7) "Foreign country" means territory not in any state;

(8) "Domiciliary state" means the state in which an insurer is incorporated or organized or, in the case of an alien insurer, the state in which the insurer has, at the commencement of delinquency proceedings, the largest amount of its assets held in trust and on deposit for the benefit of policyholders and creditors in the United States;

(9) "Ancillary state" means any state other than a domiciliary state;

(10) "Reciprocal state" means any state other than this state in which in substance and effect subsection (1) of KRS 304.33-200, subsections (1) and (3) of KRS 304.33- 530, KRS 304.33-540, and KRS 304.33-560 to 304.33-590, inclusive, are in force, and in which provisions are in force requiring that the commissioner be the receiver of a delinquent insurer, and in which some provision exists for the avoidance of fraudulent conveyances and preferential transfers;

(11) "General assets" means all property, real, personal or otherwise, not specifically mortgaged, pledged, deposited or otherwise encumbered for the security or benefit of specified persons or limited classes of persons, and as to specifically encumbered property the term includes all such property or its proceeds in excess of the amount necessary to discharge the sums secured thereby, except as otherwise expressly provided in this subtitle. Assets held in trust and on deposit for the security or benefit of all policyholders or all policyholders and creditors, in more than a single state, shall be treated as general assets;

(12) "Reinsurance intermediary" means any person who acts as a broker in soliciting, negotiating, or procuring the making of any reinsurance contract or binder, or acts as an agent in accepting any reinsurance contract or binder on behalf of an insurer;

(13) "Court" means the Franklin Circuit Court;

(14) "Preferred claim" means any claim with respect to which the law accords priority of payment from the general assets of the insurer;

(15) "Special deposit claim" means any claim secured by a deposit made pursuant to law for the security or benefit of one (1) or more limited classes of persons, but not including any claim secured by general assets;

(16) "Secured claim" means any claim secured by mortgage, trust deed, pledge, deposit as security, escrow or otherwise, but not including special deposit claims or claims against general assets including, but not limited to, claims of setoff, counterclaim, or recoupment against obligations to pay premiums to the insurer. The term also includes claims which have become liens upon specific assets by reason of judicial process, except where they have been invalidated;

(17) "Premium" has the meaning set forth in Subtitle 14 of this chapter;

(18) "Insolvency" means that the insurer is unable to pay its debts or meet its obligations as they mature or that its assets do not exceed its liabilities plus the greater of:

(a) Any capital and surplus required by law to be constantly maintained; or

(b) Its authorized and issued capital stock. For purposes of this subsection, "assets" includes one-half (1/2) of the maximum total assessment liability of the policyholders of the insurer, and "liabilities" includes reserves required by law. For policies issued on the basis of unlimited assessment liability, the maximum total liability, for purposes of determining solvency only, shall be deemed to be that amount that could be obtained if there were one hundred percent (100%) collection of an assessment at the rate of ten (10) mills;

(19) "Fair consideration" is given for property or an obligation:

(a) When in exchange for such property or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or services are rendered or obligation is incurred or an antecedent debt is satisfied; or

(b) When such property or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared to the value of the property or obligation obtained;

(20) "Creditor" is a person having any claim, whether matured or unmatured, liquidated or unliquidated, secured or unsecured, absolute, fixed or contingent;

(21) "Transfer" includes the sale and every other method, direct or indirect, of disposing of or of

parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings. The retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by the debtor;

(22)"Doing business" has the meaning designated in Subtitle 1 of this chapter; and

(23)"Guaranty association" means the Kentucky Insurance Guaranty Association, the Kentucky Life and Health Insurance Guaranty Association and any other similar entity now or hereafter created by the Legislature of this state for the payment of claims of insolvent insurers. "Foreign guaranty association" means any similar entities now in existence in, or hereafter created by the legislature of, any other state.

Ky. Rev. Stat. Ann. § 304.33-040 -- Jurisdiction and venue.

(1) Actions by commissioner. Except as provided in subsection (2) of this section, and subsection (1) of KRS 304.33-230, no delinquency proceeding shall be commenced under this subtitle by anyone other than the commissioner and no court shall have jurisdiction to entertain, hear or determine any proceeding commenced by any other person.

(2) Action by judgment creditors:

(a) The judgment creditors of three (3) or more unrelated judgments may commence proceedings under the conditions and in the manner prescribed in this subsection, by serving notice upon the commissioner and the insurer of intention to file a petition for liquidation under KRS 304.33-190 or 304.33-520. Each of the judgments must:

1. Have been rendered against the insurer by a court in this state having jurisdiction over the subject matter and the insurer;

2. Have been entered more than sixty (60) days before the service of notice;

3. Not have been paid in full;

4. Not be the subject of a valid contract between the insurer and any judgment creditor for payment of the judgment, unless the contract has been breached by the insurer; and

5. Not be a judgment on which an appeal or review is pending.

(b) If any one (1) of the judgments in favor of a petitioning creditor remains unpaid for thirty (30) days after service of the notice, and the commissioner has not then filed a petition for liquidation, the creditor may file in the name of the commissioner a verified petition for liquidation of the insurer under KRS 304.33-190 or 304.33-520 alleging the conditions stated in this subsection. The commissioner shall be served and joined in the action.

(3) Exclusiveness of proceedings.

(a) The court shall have exclusive jurisdiction to entertain, hear, or determine all matters in any way relating to any delinquency proceeding under this subtitle, including but not limited to all disputes involving purported assets of the insurer.

(b) Notwithstanding the provisions of paragraph (a) of this subsection, the court may authorize the receiver to seek injunctive or other appropriate relief from other courts, either within or without this state, if, in the opinion of the court, this action will be an aid to any delinquency proceeding.

(c) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this subtitle. No provisions in this subtitle shall be construed to preclude the court from, on its own motion, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules or to prevent an abuse of process.

(4) Change of venue. Venue for proceedings arising under this subtitle shall be laid initially as specified in the sections providing for such proceedings. All other actions and proceedings initiated by the receiver may be commenced and tried where the delinquency proceedings are then pending, or where venue would be laid by KRS Chapter 452 or other applicable law. All other actions and proceedings against the receiver shall be commenced and tried in the county where the delinquency proceedings are pending. At any time upon motion of any party, venue may be changed by order of the court or the presiding judge thereof to any other Circuit Court in this state, as the convenience of the parties and witnesses and the ends of justice may require. This subsection relates only to venue and is not jurisdictional.

(5) Personal jurisdiction, grounds for. In addition to other grounds for jurisdiction provided by the law of this state, a court of this state having jurisdiction of the subject matter shall have jurisdiction over a person served in an action brought by the receiver of a domestic insurer or an alien insurer domiciled in this state:

(a) If the person served is obligated to the insurer in any way as an incident to any agency or brokerage arrangement that may exist or has existed between the insurer and the agent or broker, in any action on or incident to the obligation;

(b) If the person served is a reinsurer who has at any time issued a contract of reinsurance to an insurer against which a rehabilitation or

liquidation order is in effect when the action is commenced, or is an agent or broker of or for the reinsurer, in any action on or incident to the reinsurance contract;

(c) If the person served is or has been an officer, manager, trustee, organizer, promoter, or person in a position of comparable authority or influence in an insurer against which a rehabilitation or liquidation order is in effect when the action is commenced, in any action resulting from the relationship with the insurer;

(d) If the person served is or was at the time of the institution of the delinquency proceedings holding assets in which the receiver claims an interest on behalf of the insurer;

(e) If the person served has filed a claim against the insurer under the provisions of KRS 304.33-360;

(f) If the person served is otherwise amenable to the exercise of personal jurisdiction by the courts of this state under the provisions of the due process clause of the Fourteenth Amendment to the United States Constitution; or

(g) If the person served is obligated to the insurer in any way in any action on or incident to the obligation.

(6) Service of process.

(a) If personal jurisdiction is authorized by this section, service of process may be made on the

person, or any agent of the person, in the county of this state where he or she may be found, or on the Secretary of State who, for this purpose, shall be deemed to be the statutory agent of the person.

(b) The clerk of the court in which the action is brought shall issue a summons against the defendant named in the complaint. The clerk shall execute the summons by sending by certified mail a true copy to the Secretary of State and shall also mail with the summons an attested copy of the complaint. The Secretary of State shall, within seven (7) days of receipt thereof in his or her office, mail the copy of the summons and complaint to the defendant at the address given in the complaint. The letter shall be posted by certified mail, return receipt requested, and shall bear the return address of the Secretary of State. The clerk shall make the usual return to the court, and, in addition, the Secretary of State shall make a return to the court showing that the acts contemplated by this statute have been performed, and shall attach to his or her return the registry receipt, if any. Summons shall be deemed to be served upon the return of the Secretary of State and the action shall proceed as provided in the Rules of Civil Procedure.

(c) The clerk mailing the summons to the Secretary of State shall mail to him or her, at the same time, a fee of ten dollars ($10), which shall be taxed as costs in the action.

(7) Forum non conveniens. If the court on motion of any party finds that any action commenced under subsection (5) of this section should as a matter of substantial justice be tried in a forum outside this state, the court may enter an order to stay further proceedings on the action in this state.

Ky. Rev. Stat. Ann. § 304.33-140 — Grounds for rehabilitation.

(1) The commissioner may apply by verified petition to the court for an order directing the commissioner to rehabilitate a domestic insurer or an alien insurer domiciled in this state on any one (1) or more of the following grounds:

(a) Any ground on which the commissioner may apply for an order of liquidation under KRS 304.33-190, whenever the commissioner believes that the insurer may be successfully rehabilitated without substantial increase in the risk of loss to creditors of the insurer or to the public;

(b) That the commissioner has reasonable cause to believe that there has been embezzlement from the insurer, wrongful sequestration or diversion of the insurer's assets, forgery or fraud affecting the insurer, or other illegal conduct in, by, or with respect to the insurer, that if established would endanger assets in an amount threatening the solvency of the insurer;

(c) That any one (1) of the following circumstances has occurred and the commissioner has reasonable cause to believe that the insurer is insolvent or that assets are endangered in an amount threatening the solvency of the insurer

1. That information coming into the commissioner's possession has disclosed substantial and not adequately explained discrepancies between the insurer's

records and the most recent annual report or other official company reports;

2. That the insurer has failed to remove any person who in fact has executive authority in the insurer, whether an officer, manager, general agent, employee, or other person, if the person has been found by the commissioner after notice and hearing to be dishonest or untrustworthy in a way affecting the insurer's business;

3. That control of the insurer, whether by stock ownership or otherwise, and whether direct or indirect, is in one (1) or more persons found by the commissioner after notice and hearing to be dishonest or untrustworthy;

4. That any person who in fact has executive authority in the insurer, whether an officer, manager, general agent, employee, or other person, has refused to be examined under oath by the commissioner concerning its affairs, whether in this state or elsewhere, and after reasonable notice of the fact the insurer has failed promptly and effectively to terminate the employment and status of the person and all his or her influence on management;

5. That the insurer has refused to submit its books, accounts, documents, or other records to the reasonable examination or inspection of the commissioner or the commissioner's authorized representative;

(d) That the insurer is or is about to become insolvent;

(e) That the insurer is engaging in a systematic practice of reaching settlements with and obtaining releases from policyholders or third-party claimants and then unreasonably delaying payment of or failing to pay the agreed upon settlements;

(f) That the insurer is in such condition that the further transaction of business would be hazardous, financially or otherwise, to its policyholders, its creditors, or the public;

(g) That within the previous twelve (12) months the insurer has systematically attempted to compromise with its creditors on the ground that it is financially unable to pay its claims in full;

(h) That without first obtaining the written consent of the commissioner, the insurer has transferred, or attempted to transfer, substantially its entire property or business, or has entered into any transaction the effect of which is to merge, consolidate, or reinsure substantially its entire property or business in or with the property or business of any other person;

(i) That the insurer or its property has been or is the subject of an application for the appointment of a receiver, trustee, custodian, conservator, or sequestrator or similar fiduciary of the insurer or its property otherwise than as authorized under this

subtitle, and that such appointment has been made or is imminent, and that such appointment might oust the courts of this state of jurisdiction or prejudice orderly delinquency proceedings under this subtitle;

(j) That within the previous year the insurer has willfully violated its charter or articles of incorporation or any insurance law or regulation of this state, or having become aware within the previous year of an unintentional violation has failed to take all reasonable steps to remedy the situation resulting from the violation and to prevent future violations;

(k) That the directors of the insurer are deadlocked in the management of the insurer's affairs and that the members or shareholders are unable to break the deadlock and that irreparable injury to the insurer, its creditors or its policyholders is threatened by reason thereof;

(l) That the insurer has failed to file its annual report or other report within the time allowed by law, and after written demand by the commissioner has failed to give an adequate explanation immediately; and

(m) That two-thirds (2/3) of the board of directors, or the holders of a majority of the shares entitled to vote, or a majority of members or policyholders of an insurer subject to control by its members or policyholders, consent to rehabilitation under this subtitle.

(2) Upon the issuance of an order directing the commissioner to rehabilitate a domestic insurer, the court shall have exclusive jurisdiction over all matters relating to the rehabilitation, including, but not limited to, the proper scope and application of the provisions of this subtitle to the rehabilitation as well as all interpretation and enforceability of all contracts of insurance to which the insurer is a party.

Ky. Rev. Stat. Ann. § 304.33-160 — Powers and duties of the rehabilitator.

(1) Special deputy. The commissioner as rehabilitator shall appoint one (1) or more special deputies, who are active or retired senior executives from a successful insurer, and who shall have all the powers and responsibilities of the rehabilitator granted under this section, and the commissioner may employ such counsel, clerks, and assistants as deemed necessary. The compensation of the special deputy, counsel, clerks, and assistants and all expenses of taking possession of the insurer and of conducting the proceedings shall be fixed by the commissioner, with the approval of the court and shall be paid out of the funds or assets of the insurer. The persons appointed under this section shall serve at the pleasure of the commissioner. If the property of the insurer does not contain sufficient cash or liquid assets to defray the costs incurred, the commissioner may advance the costs so incurred out of any appropriation for the maintenance of the Department of Insurance. Any amounts so advanced for expenses of administration shall be repaid to the commissioner for the use of the Department of Insurance out of the first available money of the insurer.

(2) General power. The rehabilitator may take action as he or she deems necessary or appropriate to reform and revitalize the insurer. He or she shall have all the powers of the directors, officers, and managers, whose authority shall be suspended, except as they are redelegated by the rehabilitator. He or she shall have full power to direct and manage, to hire and discharge employees subject to

any contract rights they may have, and to deal with the property and business of the insurer.

(3) Advice from experts. The rehabilitator may consult with and obtain formal or informal advice and aid of insurance experts.

(4) Pursuit of insurer's claims against insiders. If the rehabilitator finds that there has been criminal or tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer by any officer, manager, agent, employee, or other person, he or she may pursue all appropriate legal remedies on behalf of the insurer.

(5) Reorganization plan. The rehabilitator may prepare a plan for the reorganization, consolidation, conversion, reinsurance, merger, or other transformation of the insurer. Upon application of the rehabilitator for approval of the plan, and after the notice and hearing as the court prescribes, the court may either approve or disapprove the plan proposed, or may modify it and approve it as modified. If it is approved, the rehabilitator shall carry out the plan. In the case of a life insurer, the plan proposed may include the imposition of liens upon the equities of policyholders of the insurer, if all rights of shareholders are first extinguished. A plan for a life insurer may also propose imposition of a moratorium upon loan and cash surrender rights upon policies, for such period and to such an extent as are necessary.

(6) Fraudulent transfers. The rehabilitator shall have the power to avoid fraudulent transfers under KRS 304.33-290 and 304.33-300.

Appendix E

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
SECOND DIVISON

No. 05-CI-455

MARTIN J. KOETTERS. EXECUTIVE PLAINTIFF, DIRECTOR, KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP

Plaintiff,

vs.

ERNST & YOUNG LLP, ET AL.

Defendants.

Affidavit of David S. Meyer

STATE OF OHIO
COUNTY OF HAMILTON
SS:

I, David S. Meyer, being duly sworn and cautioned and with personal knowledge of the facts, hereby depose and state as follows:

1. I am a partner in Ernst & Young LLP.

2. Attached to this affidavit as Exhibit A is a true and accurate copy of an engagement letter between AIK Comp and Ernst & Young, LLP as retrieved from the files of Ernst & Young LLP.

FURTHER AFFIANT SAYETH NAUGHT

_____

David S. Meyer

Sworn to and subscribed before me this 18 day of April, 2005.

_____

Notary Public (Amy M. Conner)

My Commission Expires: 12/25/06

EXHIBIT A

ERNST & YOUNG
Ernst & Young llp is a member of Ernst & Young International, Ltd.

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250 East Fifth Street
Cincinnati, Ohio 45202
Phone: (513) 621-6454
www.ey.com

July 22, 2002

Mr. Maurice Turner
CEO
AIK Comp
2200 Greene Way
Suite 201
Louisville, Kentucky 40220

Dear Mr. Turner:

This will confirm our engagement letter signed in 2001 to audit and report on the financial statements of AIK Comp (AIK) for the years ending December 31, 2001 through December 31, 2003, and to prepare and sign the Company's U.S. federal and Louisville/Jefferson County (OL-3) income tax returns for the years then ended and to provide a compliance review of all state and local issues that may impact the Fund (e.g., intangible tax compliance).

Should conditions not anticipated prelude us from completing our audits and issuing the reports as contemplated by the preceding paragraph, we will advise you and the audit committee promptly and take such action, as we deem appropriate.

Our estimated audit fees for the 2002 audit are $56,825, which includes expenses. The estimated tax return review fees are $5,850 plus expenses not to exceed 10% of the base fee. These fee estimates are based on anticipated hours with strong client assistance and no unusual or new items or significant errors noted. To the extent that time is incurred in excess of anticipated hours (for instance, due to client assistance deficiencies, significant audit issues requiring additional time commitments, or similar situations), we will discuss additional billings for the excess time at a blended hourly rate.

For the audit year ending December 31, 2002, we will submit our invoices according to the following schedule and payment of them should be made upon receipt. We will provide you a schedule of invoice information for 2003 at the beginning of that audit year.

November 1, 2002	$27,000
February 28, 2003	$29,825
May 15, 2003 (50% tax progress bill)	$2,925
Invoiced and payable upon completion of tax return	$2,925 (plus expenses)

Any controversy or claim arising out of or relating to services covered by this letter or here-after provided by u s for the Fund or at its request (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Fund or of Ernst & Young LLP, or involving any person or entity for whose benefit the services in question are or were provided), shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitration, in accordance with the dispute

resolution procedures set forth in the attachment to this letter. Judgment on any arbitration award many be entered in any court having jurisdiction.

If these arrangements are acceptable, please sign this letter and return it to us at your earliest convenience.

Maurice, Larry Johnson and I very much appreciate the opportunity to serve the AIK account. We would be pleased to furnish any additional information you may request concerning our responsibilities and functions.

Very truly yours,

David S. Meyer
Partner

AIK Comp

By: _____
Mr. Maurice Turner
Chief Executive Officer

7/29/02 _____
Date

Dispute Resolution Procedures

The following procedures shall be used to resolve any controversy or claim ("dispute") as provided in our engagement letter of July 22, 2002. If any of these provisions are determined to be invalid or unenforceable, the remaining provisions shall remain in effect and binding on the parties to the fullest extent permitted by law.

Mediation

A dispute shall be submitted to mediation by written notice to the other party or parties. The mediator shall be selected by agreement of the parties. If the parties cannot agree on a mediator, a mediator shall be designated by the CPR Institute for Dispute Resolution at the request of a party. Any mediator so designated must be acceptable to all parties.

The mediation shall be conducted as specified by the mediator and agreed upon by the parties. The parties agree to discuss their differences in good faith and to attempt, with facilitation by the mediator, to reach an amicable resolution of the dispute. The mediation shall be treated as settlement discussion and therefore shall be confidential. The mediator may not testify for either party in any later proceeding relating to the dispute. No recording or transcript shall be made of the mediation proceedings.

Each party shall bear its own costs in the mediation. The fees and expenses of the mediator shall be shared equally by the parties.

Arbitration

If a dispute has not been resolved within 90 days after the written notice beginning the mediation process (or a longer period, if the parties agree to extend the mediation), the mediation shall terminate and the dispute shall be settled by arbitration. The arbitration will be conducted in accordance with the procedures in this document and the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution ("Rules") as in effect on the date of the engagement letter, or such other rules and procedures as the parties may designate by mutual agreement. In the event of a conflict, the provisions of this document will control.

The arbitration will be conducted before a panel of three arbitrators, two of whom are to be designated by the parties from the CPR Panel of Distinguished Neutrals using the screened selection process provided in the Rules. Any issue concerning the extent to which any dispute is subject to arbitration, or concerning the applicability, interpretation, or enforceability or these procedures, including any contention that all or part of these procedures are invalid or unenforceable, shall be governed by the Federal Arbitration Act and resolved by the arbitrators. No potential arbitrator shall be appointed unless he or she has agreed in writing to abided and be bound by these procedures.

The arbitration panel shall have no power to award non-monetary or equitable relief of any sort. It shall also have no power to award (a) damage3s inconsistent with any applicable agreement between the parties or (b) punitive damages or any other damages not measured by the prevailing party's actual

damages; and the parties expressly waive their right to obtain such damages in arbitration or in any other forum. In no event, even if any other portion of these provisions is held to be invalid or unenforceable, shall the arbitration panel have power to make an award or impose a remedy that could not be made or imposed by a court deciding the matter in the same jurisdiction.

Discovery shall be permitted in connection with the arbitration only to the extent, if any, expressly authorized by the arbitration panel upon a showing of substantial need by the party-seeking discovery.

All aspects of the arbitration shall be treated as confidential. The parties and the arbitration panel may disclose the existence, content or results of the arbitration only as provided in the Rules. Before making any such disclosure, a party shall give written notice to all other parties and shall afford such parties a reasonable opportunity to protect their interests.

The result of the arbitration will be binding on the parties, and judgment on the arbitration award may be entered in any court having jurisdiction.

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(2)

FILED
JAN 18 2011
OFFICE OF THE CLERK

No. 10-693

In the
Supreme Court of the United States

ERNST & YOUNG LLP, ET AL.,
Petitioners,

v.

SHARON P. CLARK, COMMISSIONER FOR THE KENTUCKY DEPARTMENT OF INSURANCE AND REHABILITATOR OF AIK COMP, ET AL.,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court of Kentucky

BRIEF IN OPPOSITION

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January 18, 2011

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QUESTION PRESENTED

Whether Petitioner presents compelling reasons to grant the Petition where the Kentucky Supreme Court properly applied the McCarran–Ferguson Act, 15 U.S.C. § 1012(b), to prevent the Federal Arbitration Act, 9 U.S.C. § 2, from preempting state-insurance law where the state court's application of federal law does not conflict with a decision of this Court, does not conflict with a decision of a federal court of appeals, and does not implicate an important and unsettled question of federal law.

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OPINIONS BELOW

The Kentucky Supreme Court's opinion is now reported at 323 S.W.3d 682, and is reproduced in the Petitioners' Appendix.[1]

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

In addition to those listed by Petitioners, Kentucky Revised Statutes Sections 304.33-150 and 304.50-110 are involved in this case. These statutes are reproduced in full starting at App. 55b.

STATEMENT OF THE CASE

1. Kentucky employs a comprehensive statutory scheme for regulating the business of insurance. The scheme consists of fifty-two subtitles within Chapter 304 (the "Kentucky Insurance Code") of the Kentucky Revised Statutes governing virtually every conceivable aspect of the business of insurance. Among the statutory provisions is an exclusive-jurisdiction statute governing all matters related to an insurance company's rehabilitation. *See* Ky. Rev. Stat. Ann. § 304.33-040(3)(a).

Congress explicitly recognized, and indeed welcomed, the states' abilities to implement comprehensive insurance codes like Kentucky's by enacting the McCarran–Ferguson Act, 15 U.S.C.

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[1] The Petitioners' Appendix is cited as Pet. App. ___, the Petition for Writ of Certiorari as Pet. ___, and the Appendix attached hereto as App. ___.

§§ 1011–15. The McCarran–Ferguson Act establishes a policy of state primacy in regulating the business of insurance.

2. Kentucky employers must maintain workers' compensation insurance for their employees. Ky. Rev. Stat. Ann. § 342.340(1). Kentucky law allows employers to pool their liabilities and qualify as a group self-insurer. Ky. Rev. Stat. Ann. § 342.350(4). AIK Comp ("AIK") has been a group self-insurer for workers' compensation liabilities for Kentucky employers since 1979. AIK's policyholders (the group members of AIK) are jointly and severally bound to pay any deficits AIK incurs. *See* Ky. Rev. Stat. Ann. § 304.50-090(1).[2]

3. AIK began to incur substantial deficits sometime in the late 1990s. App. 6b, 21b. AIK did not learn of its perilous financial condition, however, until 2004. Pet. App. 6. Shortly thereafter, the Kentucky Commissioner of Insurance filed a petition to rehabilitate AIK pursuant to Kentucky's Insurers Rehabilitation and Liquidation Law ("IRLL"), Ky. Rev. Stat. Ann. §§ 304.33-010 to -600. The petition was filed in Franklin Circuit Court as required by Kentucky law. § 304.33-040(3)(a). The circuit court ordered AIK into rehabilitation in August 2004 and further ordered, pursuant to Section 304.33-150(1), the

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[2] This requirement was previously found at 803 Ky. Admin. Regs. 25:026 § 3(f). The Kentucky General Assembly reorganized the laws governing workers' compensation self-insurance groups in 2005. Unless otherwise noted, citations are to the current statutory sections.

Kentucky Commissioner of Insurance to serve as AIK's Rehabilitator.[3] App. 8b, 42b.

Special financial examinations ultimately revealed that AIK's liabilities exceeded its assets by over $90,000,000. Pet. App. 6. Because of this deficit, thousands of injured workers in Kentucky were and are at risk of having no workers' compensation insurance to cover medical costs and indemnity payments. Many AIK policyholders intervened in the rehabilitation action to protect their injured workers and their insurance coverage. Following negotiations among various AIK policyholders and the Rehabilitator, and a full hearing, the circuit court approved a Reorganization Plan and an Assessment Plan as mechanisms to fund the crippling deficit. App. 36b–37b.

Pursuant to the Assessment Plan, the Rehabilitator issued financial assessments to approximately 3,800 AIK policyholders to remedy the deficit. Pet. App. 6–7. The Rehabilitator, under the Franklin Circuit Court's supervision, acted expeditiously to recover funds necessary to protect injured workers dependent upon AIK for workers' compensation coverage. The primary goal of the rehabilitation efforts is to ensure the payment of injured-workers' claims, obligations which can remain for an indefinite amount of time under Kentucky law. *See* Ky. Rev. Stat. Ann. § 342.020(1).

AIK policyholders could partially satisfy their assessment obligation by executing promissory notes.

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[3] The Kentucky Commissioner of Insurance is currently Sharon P. Clark.

App. 23b. To forestall having to call those notes, and consistent with the IRLL, the court-approved Reorganization Plan requires the Rehabilitator to pursue claims against those third parties whose wrongdoing caused AIK's deficits. Pet. App. 7. Any damages recovered by the Rehabilitator should reduce or eliminate the need for future assessments, and may even enable the Rehabilitator to repay some previous assessments to the AIK group members. App. 26b, 36b.

4. Kentucky's Insurance Code requires workers' compensation self-insurance funds such as AIK to undergo annual audits by an independent certified public accountant. Ky. Rev. Stat. Ann. § 304.50-110(1).[4] The audit results must be filed with the Kentucky Commissioner of Insurance as an annual statement of financial condition. *Id.* The statutorily required audits are critical to Kentucky's ability to regulate the business of insurance and to protect injured workers. Petitioners Ernst & Young LLP and David S. Meyer (collectively, "Ernst & Young") performed the statutorily mandated audits for AIK from 1998 through 2002. Pet. App. 4–6. Ernst & Young's audits of AIK's financial statements were grossly inaccurate and negligently performed.

The Rehabilitator avers that, but for these inaccuracies, AIK could have adjusted its business practices and premiums to reduce or eliminate its deficits. App. 47b–51b. Alternatively, Kentucky regulators could have placed AIK into receivership

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[4] At the relevant times, Section 342.347(2) contained the audit requirement.

when its deficit was much smaller, thereby avoiding the overwhelming policyholder assessments. App. 47b, 49b. On this basis, and after investigation, the Rehabilitator filed suit against Ernst & Young. The claims were brought pursuant to express statutory authority:

> If the rehabilitator finds that there has been criminal or tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer by any officer, manager, agent, employee, or other person, he or she may pursue all appropriate legal remedies on behalf of the insurer.

Ky. Rev. Stat. Ann. § 304.33-160(4).

The Rehabilitator's complaint alleges that Ernst & Young breached a variety of duties owed to AIK by producing inadequate and erroneous audits of financial statements. App. 47b–51b. Central to these claims are serious public-policy issues integral to Kentucky's interests both in regulating the business of insurance and in ensuring that Kentucky citizens injured in the workplace receive compensation. These claims were brought in Franklin Circuit Court pursuant to a Kentucky law requiring that court to supervise comprehensively not just AIK's rehabilitation, but also to "determine all matters in any way related to any delinquency proceeding under this subtitle, including but not limited to all disputes involving purported assets of the insurer." Ky. Rev. Stat. Ann. § 304.33-040(3)(a). Kentucky law recognizes the claims against Ernst & Young as an asset. *Button v. Drake*, 195 S.W.2d 66, 69 (Ky. 1946).

5. Ernst & Young moved the circuit court to compel arbitration pursuant to the Federal Arbitration Act (the "FAA"), 9 U.S.C. § 2, wrongly claiming that the private arbitration agreement between Ernst & Young and AIK bound the Rehabilitator. Pet. App. 31. The Franklin Circuit Court denied Ernst & Young's motion, citing the court's statutorily stated exclusive jurisdiction over any matter related to a delinquency proceeding. Pet. App. 32–34; *see* Ky. Rev. Stat. Ann. § 304.33-040(3)(a). The circuit court also ruled that the FAA is reverse-preempted by the McCarran–Ferguson Act, Pet. App. 39, and that the Rehabilitator (as a non-signatory) is not bound by the private agreement to arbitrate. Pet. App. 35–36. Clothed in the Commonwealth's police power, the Rehabilitator may revoke any private, pre-rehabilitation agreement to arbitrate. Pet. App. 38.

Ernst & Young appealed the circuit court's order denying the motion to compel arbitration. The case was transferred to the Kentucky Supreme Court, Pet. App. 27, which upheld the circuit court's denial of Ernst & Young's motion to compel arbitration based on McCarran–Ferguson reverse preemption. Pet. App. 19.

REASONS FOR DENYING THE PETITION

The question presented does not warrant this Court's review, the issue being neither disagreeable nor novel. All federal courts of appeals confronted with the question presented for review have decided in the same way as the unanimous Kentucky Supreme Court: the McCarran–Ferguson Act reverse preempts the FAA. Indeed, as discussed herein, the Court has twice considered, and twice denied, similar petitions

for writ of certiorari on virtually the same question and arguments as the instant case. *See Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277 (10th Cir. 1998), *cert. denied* 525 U.S. 1177 (1999); *Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585 (5th Cir. 1998), *cert. denied*, 525 U.S. 1016 (1998).

Ernst & Young stretches cases well outside their factual bases and legal holdings to proffer a nonexistent split of authority, employs a claims-priority case not involving the FAA to allege a failure to follow this Court's precedent, and neglects to recognize that important state-law issues make this case an inappropriate one for review. Ernst & Young's argument essentially boils down to a contention that the Kentucky Supreme Court erred in applying previously established precedent. This Court grants certiorari in only those cases involving important public matters or where there is a "real and embarrassing conflict of opinion" between the circuit courts of appeal. *Layne & Bowler Corp. v. W. Well Works, Inc.*, 261 U.S. 387, 393 (1923). The Court looks for cases "involving unsettled questions of federal constitutional or statutory law of general interest." William H. Rehnquist, *The Supreme Court: How It Was, How It Is* 269 (1987). Ernst & Young's Petition presents neither a real or embarrassing conflict of opinion nor an unsettled question of federal law.

Ernst & Young is merely asking this Court to consider setting aside well-established law and find that the FAA preempts a state law that specifically regulates the business of insurance. There being no reasonable basis under this Court's Rule 10 for granting certiorari, the Petition should be denied.

I. THERE IS NO SPLIT OF AUTHORITY ON THE QUESTION ERNST & YOUNG PRESENTS.

A. The Portion of the Sixth Circuit Opinion that Other Circuit Courts Are Alleged to Have "Disagreed" with Differs in Key Respects to the Situation Here.

1. There is no split of authority on the question actually presented by the Petition. Every federal court of appeals to have considered whether the McCarran-Ferguson Act reverse preempts the FAA has answered in the affirmative. *See Standard Sec. Life Ins. Co. of N.Y. v. West*, 267 F.3d 821 (8th Cir. 2001) (per curiam); *Davister*, 152 F.3d 1277; *Munich*, 141 F.3d 585; *Stephens v. Am. Int'l Ins. Co.*, 66 F.3d 41 (2d Cir. 1995). Ernst & Young tellingly does not allege otherwise.

Ernst & Young attempts to manufacture a "split" by proffering *AmSouth Bank v. Dale*, 386 F.3d 763 (6th Cir. 2004), a case involving neither the FAA nor a state's statutory scheme for rehabilitating or liquidating an insolvent insurer. *AmSouth* was a diversity action in which the Sixth Circuit concluded that the McCarran–Ferguson Act did not reverse preempt declaratory judgment actions against insolvent insurance companies. The court based its reasoning, in part, on its determination that the threatened declaratory judgment actions against the insurance companies had only "an attenuated connection to regulating the business of insurance." *Id.* at 783. The primary issue in *AmSouth*, however, involved forum shopping between state and federal

courts. *AmSouth* had absolutely nothing to do with the FAA.

Ernst & Young uses *AmSouth* to recast the issue here from a showdown between the McCarran–Ferguson Act and the FAA to a showdown between the McCarran–Ferguson Act and "access to other forums," specifically federal courts. Pet. at 30. This sleight-of-hand does not manufacture the basic grounds for certiorari. Nonetheless, Ernst & Young heavily relies upon *AmSouth,* using it to underpin its arguments for an alleged circuit split on the question presented and for the Kentucky Supreme Court's alleged errors.

2. *AmSouth*'s facts and procedural posture are so distinguishable as to make it irrelevant. First, the instant case is not a declaratory judgment action; rather, it is an action against Ernst & Young to protect and secure assets for AIK's policyholders. Second, unlike *AmSouth*, the Rehabilitator's prosecution of this action and collection of assets directly advance the interests of the policyholders and injured workers dependent on AIK for medical and indemnity payments. They, and not shareholders or outsiders, are the sole beneficiaries of this action. Third, this action explicitly derives from Kentucky's statutory scheme which regulates the business of insurance. This action is not a garden-variety common-law-damages suit tangentially related to Kentucky's IRLL. Fourth, this action was properly filed in the Franklin Circuit Court pursuant to the exclusive-jurisdiction provision set forth in Kentucky's IRLL. A similar exclusive-jurisdiction provision was not at issue in *AmSouth*. Moreover, the claims in this case, unlike

those in *AmSouth*, arise from the rehabilitation orders issued pursuant to the IRLL.

Finally, *AmSouth* did not involve Ohio's statutory scheme relating to insurer liquidations. In fact, *AmSouth*'s discussion of McCarran–Ferguson did not describe or even reference state statutory schemes. Although cases construing Ohio's statutory scheme were cited, Ohio's statutory scheme was not at issue. In short, *AmSouth* is inapposite.

3. Ernst & Young compares the allegedly "attenuated" connection between the regulation of insurance and the Rehabilitator's claims against Ernst & Young to the "attenuated" connection with the insurance issues in *AmSouth*. Pet. 27–28. But the attenuation in *AmSouth* derived from the case being only a declaratory judgment action. 386 F.3d at 783 ("Here, of course, the Banks seek only declaratory judgment, based in turn on a threatened ordinary common-law action against them, and the assets of the insurance companies are up for grabs only in that attenuated fashion.").

This case is no declaratory judgment action. It is a coercive action to recover damages for negligent performance of statutorily required audits—audits required by Kentucky's insurance law as an express part of the regulation of the business of insurance. Or, as the Kentucky Supreme Court wrote:

> We can hardly overstate the degree to which the regulation of insurance permeates this controversy. The very claims which Ernst & Young would take to arbitration arise directly out of Kentucky's intense interest in the

> regulation of worker's compensation insurance. The audits that form the core of the Rehabilitator's claims were performed by Ernst & Young for AIK Comp to comply with state insurance regulations which include a review of such audits by the state's insurance commissioner to monitor the solvency of AIK Comp. *The IRLL is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company.*

Pet. App. 12 (emphasis added). There is nothing "attenuated" about the manner in which assets are at issue here.

The Rehabilitator's ability to bring claims against Ernst & Young is specifically derived from the Kentucky Insurance Code and would not exist otherwise. *AmSouth* recognizes the importance of this distinction, noting that "[t]his dispute involves the Receivers' attempt to recover money in an ordinary common-law-damages suit; the Banks do not here attempt to disrupt a coherent state scheme in favor of enriching their own pockets." *AmSouth*, 386 F.3d at 780.

In *AmSouth*, no state statutory provision created duties or liabilities upon banks in handling transactions with insurance companies. Contrast that with Kentucky's statutory audit requirements. AIK, and all other insurers doing business in Kentucky, must procure audits from independent third parties each year that demonstrate the insurer's financial solvency. Ky. Rev. Stat. Ann. § 304.50-110(1).

Furthermore, Kentucky's Insurance Code prohibits inaccurate or misleading financial statements. *See* Ky. Rev. Stat. Ann. § 304.12-040; § 304.50-110(5). The Rehabilitator is statutorily required to pursue claims against any person who tortiously performed tasks required by the Kentucky Insurance Code. *See* § 304.33-160(4); Pet. App. 7. The Rehabilitator's claims must be brought in a specific state court, the Franklin Circuit Court. *See* § 304.33-040(3)(a).

Ultimately, *AmSouth* is useless to Ernst & Young. *AmSouth* announces no disagreement with other circuits on any relevant McCarran–Ferguson issue presented here. It takes no issue whatsoever with other circuit courts of appeals that have specifically held that the McCarran–Ferguson Act reverse preempts the FAA. Indeed, *AmSouth* is silent with regard to the relationship between the McCarran–Ferguson Act and the FAA. *AmSouth* applies only when there is an "attenuated" relationship between the claims at issue and the state insurance law sought to be preempted. Ernst & Young cannot show such "attenuation," regardless of how frequently it labels itself as a mere "third party," dismisses the Rehabilitator's claims as "garden variety" or "incidental," or refers to the relationship of its audits with Kentucky insurance law as "attenuated." The stubborn facts remain and defy such facile and misleading characterizations. The Kentucky Supreme Court correctly found that the Rehabilitator's claims are "an essential component of AIK Comp's rehabilitation." Pet. App. 18. There is nothing "attenuated" about it.

B. The Other Cases Cited by Ernst & Young that Allegedly Reflect a Circuit Split Are Not on Point.

The other cases cited by Ernst & Young for the alleged circuit split are equally unavailing. Ernst & Young concedes that *Garcia v. Island Program Designer, Inc.*, 4 F.3d 57 (1st Cir. 1993), is not factually applicable to this case. Pet. 33. Nonetheless, Ernst & Young cites the case for its "reasoning." But reasoning does not create split authority—only holdings do. Furthermore, the First Circuit has itself recognized the criticism *Garcia* has undergone. *See Ruthardt v. United States*, 303 F.3d 375, 384–86 (1st Cir. 2002).

The final case Ernst & Young cites as creating a split in authority resolved an issue of federal court jurisdiction. In *Gross v. Weingarten*, 217 F.3d 208 (4th Cir. 2000), the court held that the McCarran–Ferguson Act does not reverse preempt the federal diversity jurisdiction statute, but noted that on certain matters federal courts should avoid disrupting "'state efforts to establish a coherent policy with respect to a matter of substantial public concern'" by exercising restraint through abstention. *Id.* at 222–23 (quoting *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 491 U.S. 350, 361 (1989)). Once again, neither arbitration nor the FAA was at issue. Ernst & Young cites no case that resolves the exact question presented other than in the Rehabilitator's favor.

None of *AmSouth*, *Gross*, or *Garcia* involved workers' compensation group self-insurance companies, meaning any benefits sought in those cases would redound to shareholders. This distinction is crucial because it removes any "attenuation." Here,

policyholders and injured workers ultimately receive any benefit gained. Thus, the applicability of cases like *AmSouth* and *Garcia* that relied on such attenuated circumstances is undermined. *See AmSouth*, 386 F.3d at 783; *Garcia*, 4 F.3d at 62. This Court should deny review where no lower courts express diverging views on the narrow question presented.

II. THE KENTUCKY SUPREME COURT'S ANALYSIS OF THE MCCARRAN-FERGUSON ACT'S REACH IS FULLY CONSISTENT WITH THIS COURT'S PRECEDENTS.

Ernst & Young argues that the Kentucky Supreme Court failed to comply with this Court's reasoning in *United States Department of Treasury v. Fabe*, 508 U.S. 491 (1993). Ernst & Young's new-found reliance upon *Fabe* is an interesting tactic. Ernst & Young did not argue *Fabe* in its briefs to the Kentucky Supreme Court, and, as it states in its Petition, specifically raised and primarily argued *Fabe* for the first time during oral arguments. *See* Pet. 10 (referencing Ernst & Young's primary argument during briefing); *see also Hormel v. Helvering*, 312 U.S. 552, 556 (1941) ("Ordinarily an appellate court does not give consideration to issues not raised below."). Nevertheless, the Kentucky Supreme Court's decision is fully consistent with this Court's reasoning in *Fabe*.

A. *Fabe* Is a Claims-Priority Case that Does Not Involve the FAA.

In *Fabe*, the Court considered a conflict between an Ohio statute conferring only fifth priority upon claims

of the United States in proceedings to liquidate an insolvent insurer and a federal statute according first priority to the United States. 508 U.S. at 493. The Court held that the McCarran-Ferguson Act applied and prevented federal preemption to the extent that the Ohio statute protects policyholders. *Id.* The Court further found that the "broad category of laws enacted 'for the purpose of regulating the business of insurance' . . . necessarily encompasses more than just the 'business of insurance.'" *Id.* at 505 (internal citation omitted). Ernst & Young conveniently ignores this holding in its Petition.

Fabe did not involve the relationship between the McCarran–Ferguson Act and the FAA. *Fabe* is merely a claims-priority case setting forth an analysis consistent with the Kentucky Supreme Court's opinion. As set forth herein, *Fabe* hurts, rather than helps, Ernst & Young.

Section 2(b) of the McCarran–Ferguson Act provides, in pertinent part, that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b). In reliance upon that language, *Fabe* sets forth a three-part test for determining if the McCarran–Ferguson Act should be applied: (1) does the federal statute at issue, i.e., the FAA, "specifically relate to the business of insurance"; (2) was the state statute enacted "for the purpose of regulating the business of insurance"; and (3) would application of the federal statute "impair, invalidate, or supersede" the state statute. 508 U.S. at 500–01.

There is no dispute here as to the first part of the test because the FAA does not specifically relate to the business of insurance. Ernst & Young wrongly contends that the Kentucky Supreme Court erred in its analysis of parts two and three of the test set forth in *Fabe*.

B. According Preemptive Effect to the FAA Would Invalidate, Impair, and Supersede Kentucky Laws Regulating the Business of Insurance in Violation of the McCarran-Ferguson Act.

1. The Kentucky Supreme Court correctly found AIK's rehabilitation to be proceeding under laws enacted to regulate the business of insurance. In *Fabe*, this Court held that state laws governing even insurance company *liquidation*, "at which point the insurance company no longer exists," are enacted "for the purpose of regulating the business of insurance." *Id.* at 505–06. If insurer liquidation laws regulate the business of insurance, then surely insurer *rehabilitation* laws do. Even the dissenters in *Fabe* would agree. The dissent recognized policyholders' "vital interest in the financial strength and solvency of their insurers," but concluded that state priority laws in liquidation proceedings do not regulate the "business of insurance" simply because it is "too late" at the liquidation stage to "increase the reliability or the solvency of the insurer." *Id.* at 513 (Kennedy, J., dissenting). The dissent's reasoning underscores the key difference here. It is not too late at the rehabilitation stage to "increase the reliability or the solvency of the insurer" and to protect the policyholders' "vital interest" in AIK's "financial

strength and solvency." The Rehabilitator's claims against Ernst & Young are critical to the "financial strength," "solvency," and "reliability" of AIK and central to the proceedings Kentucky law comprehensively assigns to the Franklin Circuit Court. Both *Fabe*'s majority opinion and dissent support McCarran–Ferguson reverse preemption of the FAA.

2. Next, the McCarran–Ferguson Act applies because preemption by the FAA would "invalidate," "impair," and "supersede" Kentucky's rehabilitation law. Removing key issues from the Franklin Circuit Court and assigning them to an arbitrator is clearly at odds with Kentucky law. This case therefore meets the test set forth in *Humana Inc. v. Forsyth,* 525 U.S. 299 (1999), for the meaning of the words "invalidate, impair, or supersede" as used in the McCarran–Ferguson Act, and the Kentucky Supreme Court properly framed (and answered) the question before it under the *Forsyth* framework.

Forsyth teaches that preemption of state insurance law is permitted only if the preempting "federal law does not directly conflict with state regulation, and when application of the federal law would not frustrate any declared state policy or interfere with a state's administrative scheme." *Id.* at 310. Here, giving preemptive effect to the FAA would "frustrate" the "declared state policy" and "interfere with a State's administrative scheme" because it would force the Rehabilitator to take her claims from the statutorily mandated court-rehabilitation proceedings and bring them instead before an arbitrator. The Rehabilitator exercises the Commonwealth's police power in this regard. *See Minor v. Stephens,* 898 S.W.2d 71, 78 (Ky. 1995). Subordinating that authority to a private

contract, in direct contradiction to the express terms of Section 304.33-010(6), "interferes" with the Commonwealth's "declared" policy and would seriously undercut its regulatory scheme. An arbitrator, rather than the rehabilitation court, would determine key issues related to the deceptive audits that led to AIK's collapse; this substitution directly contradicts the express terms of Section 304.33-040(3)(a). Removing issues from rehabilitation proceedings, particularly if the issues to be removed are as vital as those at issue here, "impairs" state law requiring comprehensive proceedings under the supervision of a single managing court. *See, e.g.*, *Davister*, 152 F.3d at 1281.

The Kentucky Supreme Court's decision is solidly grounded in applicable law. The FAA directly conflicts with Kentucky laws governing comprehensive insurer rehabilitation proceedings. The McCarran–Ferguson Act protects the Kentucky Insurance Code.

C. Ernst & Young's Claim that the Kentucky Supreme Court's Decision Expands the McCarran–Ferguson Act Beyond Limits Set by this Court Mischaracterizes the Law, the Nature of Its Dispute with the Rehabilitator, and the Kentucky Supreme Court's Analysis.

Ernst & Young asserts that the Kentucky Supreme Court failed to comply with *Fabe* in that it conducted the reverse-preemption analysis by focusing only "on the Liquidation Law as a whole, rather than the particular application of the sections at issue." Pet. 17. Only by employing this overbroad focus, Ernst & Young contends, was the Kentucky Supreme Court

able "to hold that its anti-arbitration implementation of the exclusive-jurisdiction provision could be applied to this garden-variety tort dispute between the insurer and a third party." Pet. 17. Ernst & Young errs in a variety of ways.

1. Ernst & Young's characterization of this dispute as "garden variety" and of itself as a mere "third party" otherwise not implicated in the rehabilitation is specious (as if it had been selling office supplies rather than providing audit reports to state regulators). Ernst & Young simply cannot create any meaningful distance between its role as auditor and Kentucky's regulation of the business of insurance. Indeed, Ernst & Young previously conceded this very point to the Kentucky Supreme Court.[5]

2. Even a cursory review of the Kentucky Supreme Court's opinion proves that it did look at the "particular application" of the Kentucky insurance law sections that were directly "at issue," as well as the specific ways that Kentucky insurance law would be invalidated, impaired, and superseded by removing the Rehabilitator's action against Ernst & Young from the rehabilitation proceeding. The court noted that Section 304.33-010(6) expressly subordinates "any contractual provision" in conflict with Kentucky's

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[5] As the Kentucky Supreme Court explained, Ernst & Young insisted that its audits were "matters 'relating to Kentucky's Workers' Compensation Statutes'" when the members signed agreements making AIK their "agent." Pet. App. 23–24. Thus, Ernst & Young strongly embraced the close relationship of its audits to Kentucky insurance law when convenient, but now revises its characterization of that relationship for purposes of its Petition.

insurance law "if there is a delinquency proceeding," and explained that here "the Rehabilitator has been charged to 'pursue all appropriate legal remedies on behalf of the insurer.'" Pet. App. 17. The court further explained that Ernst & Young's involvement is integral to Kentucky's regulation of insurance: "[T]he Rehabilitator's claims against Ernst & Young are an essential component of AIK Comp's rehabilitation." Pet. App. 18. The claims "fall squarely within the scope of KRS 304.33-040(3)(a), as 'matters . . . relating to [a] delinquency proceeding under this subtitle, including . . . all disputes involving purported assets of the insurer,' and therefore, under KRS 304.33-010(6) remain within the exclusive jurisdiction of the Franklin Circuit Court." Pet. App. 18.

Having established a conflict between application of the FAA and Kentucky law regulating the business of insurance, the court then analyzed the specific ways that Kentucky law would be frustrated by FAA preemption. Removing the Rehabilitator's claims against Ernst & Young from the rehabilitation proceedings would eviscerate the trial court's "broad discretion to decide all issues pertaining to pre-hearing procedures, including discovery, all issues of substantive law, and all evidentiary matters." Pet. App. 18. Kentucky's General Assembly did not contemplate "[s]uch a substantial reduction of the court's role" in "issues critical to the state's interest in the rehabilitation or liquidation of the insurance company." Pet. App. 19. Having carefully analyzed the *specific* effects of the *specific* conflict between the FAA and the sections of the Kentucky Insurance Code sought to be preempted, the Kentucky Supreme Court concluded that the FAA's "preference for arbitration conflicts with, and impairs, the IRLL's grant of broad

and exclusive jurisdiction to the Franklin Circuit Court." Pet. App. 19. Therefore, McCarran–Ferguson reverse preemption applied.

3. Ernst & Young ignores, and asks this Court to ignore, the Kentucky Supreme Court's detailed analysis of the specific impairment to Kentucky insurance law that would result from FAA preemption. Instead, Ernst & Young asserts that "the Kentucky Supreme Court focused on the purpose of the Liquidation Law as a whole — rather than the specific provisions of that law which would be 'invalidate[d], impair[ed], or supersede[d]' by the FAA." Pet. 16 (alterations in original). Ernst & Young constructs an argument on this erroneous assertion that the Kentucky Supreme Court's decision conflicts with *Fabe*.

Having set up its straw man, Ernst & Young proceeds to demolish it, devoting page after page to its argument that *Fabe* requires consideration of the specific effect the proposed preemption would have on specific provisions of that law.[6] This is, of course, simply another way of saying that the McCarran–Ferguson Act requires a showing that state law regulating the business of insurance would be invalidated, impaired, or superseded if preempted. *See* 15 U.S.C. § 1012(b). But it is certainly not accurate to compare the partial preemption approved in *Fabe* to the case at bar. Partial preemption of the Ohio

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[6] The Court did engage in statutory parsing in *Fabe*. Nonetheless, "the Court stopped short of directing that this approach be taken in every case." *Munich*, 141 F.3d at 592 (citing *Fabe*, 508 U.S. at 509 n.8).

priority statute at issue in *Fabe* did not "impair" Ohio's regulation of the business of insurance for the simple reason that the Ohio statutory subsection at issue had nothing to do with the state's interest in regulating the "business of insurance." On the other hand, consolidating all rehabilitation matters in Franklin Circuit Court, particularly matters as vital as Ernst & Young's erroneous audits, directly advances the state's interest in regulating the business of insurance.

In fact, *Fabe* damages Ernst & Young's Petition. After all, the *Fabe* Court protected every portion of Ohio's priority statute that it reasonably could. Under *Fabe*, a state statute regulates "the business of insurance" if it "serves to ensure that, if possible, policyholders ultimately will receive payment on their claims." 508 U.S. at 506. As here, *Fabe* upheld by reverse preemption state preferences for policyholders and liquidation expenses because they "*further the goal of protecting policyholders.*" *Id.* at 509 (emphasis added).

That is precisely what the Kentucky statutes under attack here do: protect policyholders and ensure payment of policyholders' and injured-workers' claims. The clarity of that goal is underscored where, as here, there are no shareholders, but only members who self-insure. Any benefits gained from the suit in Franklin Circuit Court will inure solely to AIK's policyholders and the injured workers dependent upon a solvent AIK.[7]

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[7] Kentucky's workers' compensation statute "is one of the more liberal among the various states in that it obligates the employer for full payment of medical and related benefits." Norman E.

Indeed, this action directly advances the interests of insureds, policyholders, and the state on numerous levels. The IRLL itself specifies the purposes of the code: "enhanced efficiency and economy of liquidation" through consolidation of proceedings in a single court "so as to avoid divergent rulings by a multiplicity of judicial tribunals and through clarification and specification of the law," Ky. Rev. Stat. Ann. § 304.33-010(4)(c); "[r]egulation of the insurance business" by imposing substantive rules, § 304.33-010(4)(f); and provision of a "comprehensive scheme for the supervision, rehabilitation, and liquidation of insurance companies *and* those subject to this subtitle as part of the regulation of the business of insurance," § 304.33-010(4)(g) (emphasis added). The Rehabilitator's claims, placed under the Franklin Circuit Court's comprehensive management and sole jurisdiction, advance these purposes.

Ernst & Young's argument rests on convincing this Court of two things: (1) that the Kentucky Supreme Court did not perform the reverse-preemption analysis at a focused level on the particular statutes affected, thereby violating *Fabe;* and (2) that Ernst & Young's role in the financial collapse of AIK is so peripheral to the rehabilitation proceedings that the court erred in applying the analysis that pertains when the statute was enacted "for the purpose of regulating the business of insurance." Ernst & Young is wrong on both counts.

Harned, *Kentucky Workers' Compensation* § 2.01 (3d ed. 2004). Kentucky imposes no time or amount limitation on the payment of medical benefits, along with providing disability payments, lost-income benefits, and death benefits. *See* Ky. Rev. Stat. Ann. § 342.020; § 342.040; § 342.160; § 342.730.

III. THE KENTUCKY SUPREME COURT'S DECISION SQUARES WITH OTHER COURTS THAT HAVE ADDRESSED REVERSE PREEMPTION OF THE FAA.

A. The Circuits Are in Accord with the Kentucky Supreme Court.

Numerous courts have rejected FAA preemption under the circumstances here. These courts have emphasized that comprehensive proceedings with exclusive jurisdiction in a single state court advance policyholders' interests. *See, e.g.*, *Davister*, 152 F.3d at 1281; *Munich*, 141 F.3d at 593.

1. For instance, in *Munich*, a creditor-reinsurer sued the liquidator of an insolvent insurer over an alleged debt. *See* 141 F.3d at 587. The Oklahoma Insurance Commissioner, serving as liquidator, would not submit to arbitration with the creditor-reinsurer. The Fifth Circuit refused to compel arbitration, holding that the state insurance liquidation act reverse preempted the FAA. *See id.* Specifically, the Fifth Circuit applied *Fabe* and held that state laws granting exclusive jurisdiction to state courts in insurance-insolvency matters regulate the business of insurance. *Id.* at 592–93. Consolidating all claims against the insolvent insurer's limited assets in one court prevents the wasting of estate funds that necessarily would occur if the liquidator was forced to defend different suits brought by different claimants in different forums. *Id.* at 593. In sum, state court exclusive jurisdiction is "reasonably necessary" to advance the goal of protecting policyholders. *See id.* at 594.

The creditor-reinsurer in *Munich* filed a petition for a writ of certiorari. This Court denied that petition. 525 U.S. 1016. Ernst & Young has asserted virtually the same issue and alleged the same conflicts as the petitioner in *Munich*.

2. Similarly, in *Davister*, the Tenth Circuit applied the three-part test set forth in *Fabe* to uphold the United States District Court for Utah's decision not to compel arbitration of a dispute involving an insurer in liquidation. *See* 152 F.3d at 1281–82. The aggrieved party in that case also filed a petition for a writ of certiorari with this Court. The Court also denied that petition. 525 U.S. 1177.

The *Munich* and *Davister* courts both recognized that, by definition, an insurance company in rehabilitation or liquidation has little cash to spare. Litigation in multiple forums is needless and expends precious resources that could otherwise be used to strengthen the insurer's solvency or to pay claims. *Davister*, 152 F.3d at 1281; *Munich*, 141 F.3d at 593. "Consolidation also eliminates the risk of conflicting rulings, piecemeal litigation of claims, and unequal treatment of claimants, all of which are of particular interest to insurance companies and policyholders, who are often relying on policies with the same or similar provisions." *Munich*, 141 F.3d at 593.

3. Policyholders also benefit from the openness and publicity surrounding court proceedings, as well as extended discovery. *See* Susan Randall, *Mandatory Arbitration in Insurance Disputes: Inverse Preemption of the Federal Arbitration Act*, 11 Conn. Ins. L.J. 253, 258 (2005). Arbitration often occurs behind closed doors and the resulting decision is made confidential.

Id. This should not be so in a matter of such public interest. AIK provided not just insurance; it provided workers' compensation insurance. Workers' compensation insurance serves a key public policy by enforcing a trade-off between employer and employee in exchange for stability and confidence. *See Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co.*, 547 U.S. 651, 655 (2006) (discussing the trade-off). Open court proceedings that fully display negligent practices decrease the likelihood, if only from a public-relations perspective, of future transgressions. Policyholders benefit from the cleansing effect of such sunshine and the evidentiary and civil rules provided by litigation in a court. Randall, *supra*, at 258. Stripping the Franklin Circuit Court of its exclusive jurisdiction over this matter in favor of arbitration would prevent this result.

Finally, Kentucky's exclusive-jurisdiction provision regulates the business of insurance in two other ways. First, it transfers or spreads risks by "introducing the possibility of jury verdicts into the process for resolving disputed claims."[8] *West*, 267 F.3d at 824; *McKnight v. Chi. Title Ins. Co.*, 358 F.3d 854, 858 (11th Cir. 2004) (per curiam) (quoting *West*). Full discovery practice that reveals the legal issues and

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[8] The Center for Audit Quality's amicus brief alludes to "concerns of state parochialism." Brief for The Center for Audit Quality as Amicus Curiae Supporting Petitioner 16. The Center fails to recognize that the Franklin Circuit Court (located in Kentucky's capital city) is Kentucky's equivalent of the United States District Court for the District of Columbia. The Franklin Circuit Court rules for and against the Commonwealth on a regular basis. Furthermore, post-trial motion practice and appeals provide remedies for these illusory and insulting concerns.

business decisions that led to financial disaster, followed by a jury trial on all relevant claims, increases the likelihood that policyholder claims will be paid to a degree that arbitration cannot match. *Cf. Fabe*, 508 U.S. at 505–06 (protecting a statute from FAA preemption "to the extent that it serves to ensure that, if possible, policyholders will ultimately receive payment on their claims"); Randall, *supra*, at 258.

Second, the statute "expressly invalidat[es] the parties' chosen mode of contract enforcement." *McKnight*, 358 F.3d at 858; *see also West*, 267 F.3d at 824. McCarran–Ferguson allows states to deny the deployment of smokescreens to hide complicity. The Kentucky legislature invoked its right under the McCarran–Ferguson Act to require that claims against a tortfeasor be presented in open court when the tortfeasor's actions allegedly contributed to an insurer's demise. This election of rights is particularly relevant where the insurer's downfall was allegedly caused by the negligent performance of a statutorily required duty. Ernst & Young cannot hide behind the secrecy of arbitration proceedings against a party that never agreed to arbitrate. These accepted measures for regulating the business of insurance support the Kentucky Supreme Court's holding.

B. The Second Circuit Previously Held Kentucky's IRLL Regulates the Business of Insurance.

Ernst & Young challenges portions of the Kentucky IRLL that previously withstood attack in the Second

Circuit.[9] In *Stephens*, the Second Circuit held that a Kentucky statute prohibiting arbitration of claims involving insurers in rehabilitation or liquidation reverse preempted the FAA. 66 F.3d at 42. The Second Circuit specifically rejected the claim that Kentucky's anti-arbitration provisions did not regulate the business of insurance after applying the principles of *Fabe, Union Labor Life Insurance Co. v. Pireno*, 458 U.S. 119 (1982), and *Group Life & Health Insurance Co. v. Royal Drug Co.*, 440 U.S. 205 (1979). *See Stephens*, 66 F.3d at 45. Rather, the court wrote that the Kentucky IRLL "'protects' policyholders . . . by assuring that an insolvent insurer will be liquidated in an orderly and predictable manner and the anti-arbitration provision is simply one piece of that mechanism." *Id.* at 45. Contrary to Ernst & Young's assertions, nowhere does *Stephens* indicate that it is bound to its insurer-versus-reinsurer facts. Pet. 31. The *Stephens* court instead analogized the insurer-reinsurer relationship to that between an insurer and policyholder and then applied the generally applicable rules for determining whether a statute regulates the business of insurance. *Stephens*, 66 F.3d at 44.

Like *Stephens*, the exclusive-jurisdiction provision here protects policyholders by ensuring "orderly and predictable" proceedings for insolvent insurers. Bankruptcy protection is unavailable for insurance

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[9] The Kentucky General Assembly amended the challenged statute in the wake of *Stephens v. Am. Int'l Ins. Co.*, 66 F.3d 41 (2d Cir. 1995), to recognize that agreements between an insurer and reinsurer may be submitted to arbitration. *See* Ky. Rev. Stat. Ann. § 304.33-101(6); 1996 Ky. Acts ch. 183, § 1. As Ernst & Young notes, however, the "change is immaterial here." Pet. 31 n.1.

companies. *Fabe*, 508 U.S. at 519 (Kennedy, J., dissenting). Instead, state law protects insolvent insurers by consolidating all actions related to rehabilitation or liquidation in a single court. *See Munich*, 141 F.3d at 593 ("The experience of the federal bankruptcy courts, which evidences the importance of consolidating all of the assets of an insolvent company and the claims against those assets in a single forum, supports the legitimacy of the Oklahoma scheme in protecting the interests of policyholders."). The McCarran–Ferguson Act places the onus on states to provide such protections, and, as *Stephens* demonstrates, Kentucky accepted the responsibility.

C. The Claims Against Ernst & Young Concern the Business of Insurance, a Subject of State Regulation Protected by the McCarran–Ferguson Act.

1. This Court has recognized that the McCarran–Ferguson Act made the "business of insurance" a subject of state regulation. In *American Insurance Ass'n v. Garamendi*, 539 U.S. 396, 427–28 (2003), the Court wrote that "'[t]he business of insurance' shall be recognized as a subject of state regulation, which will be good against preemption by federal legislation unless that legislation 'specifically relates to the business of insurance.'" (Internal citations omitted.)

Congress has unquestionably left the regulation of the "business of insurance" to the states. State statutes aimed at "protecting or regulating" the relationship between insurer and insured, either

"directly or indirectly, are laws regulating the 'business of insurance.'" *See SEC v. Nat'l Sec., Inc.*, 393 U.S. 453, 460 (1969). AIK was in the business of insurance;[10] Kentucky's Insurance Code regulates the business of insurance; Kentucky's statutes and regulations requiring insurers to file audit reports with state regulators protects insureds; and, now that AIK is in rehabilitation, Kentucky's IRLL protects the interests of insureds, creditors, and the general public.

However the Court looks at it, AIK was and is in the business of insurance, and Ernst & Young's audit of AIK was an integral and required part of Kentucky's comprehensive statutory scheme to regulate and to protect the relationship between the insurer and insured. *See* Ky. Rev. Stat. Ann. § 304.33-010(5) ("All persons who voluntarily transact business with an insurer which is subsequently the subject of a delinquency proceeding under this subtitle shall be conclusively presumed to have transacted business with the intent that the provisions of this subtitle would control if there is any delinquency proceeding in this state.").

Ernst & Young's transparent attempt to recast itself as something akin to a third-party bystander must fail. The Commonwealth of Kentucky has squarely addressed all of the issues involved in the regulation and rehabilitation of a self-insurance fund like AIK, including the audits of those funds. Ernst & Young has conceded the close relationship between its

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[10] The Sixth Circuit has specifically held that AIK provided insurance to its members. *See Associated Indus. of Ky., Inc. v. U.S. Liab. Ins. Group*, 531 F.3d 462, 467 (6th Cir. 2008).

auditing function and Kentucky insurance law. There is simply no way to separate Ernst & Young's audit of AIK from the state-regulated "business of insurance."

2. Of course there are cases where a state law was preempted because it, unlike Kentucky's auditing and rehabilitation laws, was not enacted for the purpose of regulating the "business of insurance." There are also cases where state insurance law did not conflict with the federal law sought to be reverse preempted and was not, as a result, impaired. Ernst & Young cites such cases, including *Fabe*. Ernst & Young also cites *Royal Drug*, an antitrust case alleging that an insurer and three pharmacies indulged in price-fixing of drugs and group boycott. *See* 440 U.S. at 207. Ernst & Young discusses both at length despite the lack of relevance. Neither *Royal Drug* nor *Fabe* provides the slightest support to Ernst & Young's contention that its role here is removed from the state's regulation of the business of insurance. The same is true of *Pireno*, also cited by Ernst & Young. *Pireno*, like *Royal Drug*, involved Sherman Act antitrust price-fixing claims and therefore an entirely different provision of the McCarran–Ferguson Act than that at issue here. *Pireno*, 458 U.S. at 122. Moreover, the Court in *Fabe* expressly cautioned against reading these cases as broadly as Ernst & Young does:

> But we do not read *Pireno* to suggest that the business of insurance is confined entirely to the writing of insurance contracts, as opposed to their performance. *Pireno* and *Royal Drug* held only that "ancillary activities" that do not affect performance of the insurance contract or enforcement of contractual obligations do not

> enjoy the antitrust exemption for laws regulating the "business of insurance."

Fabe, 508 U.S. at 503.

Ernst & Young's role in this rehabilitation is not merely "ancillary." The Kentucky Supreme Court correctly, and soundly, rebuffed Ernst & Young's argument that it is:

> Far from being just a coincidental aspect of a "garden variety" claim, AIK Comp's insolvency was allegedly caused by Ernst & Young's audits which masked AIK Comp's true financial condition. Under the Reorganization Plan approved by the Franklin Circuit Court, the Rehabilitator's claims against Ernst & Young are an essential component of AIK Comp's rehabilitation.

Pet. App. 17–18.

The Kentucky Supreme Court's reasoning on the McCarran–Ferguson Act issue is impeccable, and its compliance with applicable law obvious. There is no reason for this Court to review the Kentucky Supreme Court's rejection of Ernst & Young's attempt to distance itself from Kentucky's efforts to rehabilitate AIK. The Petition should be denied.

IV. THIS CASE IS AN IMPROPER VEHICLE TO RESOLVE ANY PERCEIVED DISAGREEMENT.

Certiorari is improvident where, as here, state-law issues may prevent the Court from reaching the

question or render the Court's decision moot as to the parties. In other words, granting the Petition will not change the ultimate outcome.

1. The Kentucky Supreme Court specifically focused its opinion on the McCarran–Ferguson reverse-preemption issue. The court did not consider other issues that were decided below, then briefed and argued before the court. Therefore, this is not currently an independent and adequate state grounds case because no "plain statement" exists. *See Michigan v. Long*, 463 U.S. 1032, 1041 (1983).

Nonetheless, the Franklin Circuit Court's opinion and order did address all issues brought before that court. Predominant among the circuit court's holdings is that any alleged arbitration agreement is not enforceable against the Rehabilitator because she did not sign it and because there are no grounds to support enforcement against her. *See* Pet. App. 35–36. ("There exist no facts which support commonly recognized reasons for applying a contractual agreement to a nonsignatory."). In *Arthur Anderson LLP v. Carlisle*, 129 S. Ct. 1896, 1902 (2009), this Court reiterated that state law governs the enforceability of agreements to arbitrate, including alleged agreements with nonparties. *See also Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987) (noting that "state law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally" (emphasis in original)); *First Options of Chi., Inc. v. Kaplan*, 514 U.S. 938, 944 (1995) ("When deciding whether the parties agreed to arbitrate a certain matter (including arbitrability), courts generally . . . should apply ordinary state-law principles that govern

the formation of contracts."). That principle applies here; thus, without a valid arbitration agreement, no federal question exists.

Kentucky law holds that the Rehabilitator is not bound by the arbitration agreement because she did not sign it. *See, e.g.*, *Olshan Foundation Repair and Waterproofing v. Otto*, 276 S.W.3d 827, 831 (Ky. Ct. App. 2009). If this Court grants certiorari and reverses, the issue would be taken up on remand, decided in the Rehabilitator's favor, and Ernst & Young would have suffered a hollow victory.

2. None of the theories recognized for binding nonsignatories to arbitration agreements justify binding the Rehabilitator here. *See, e.g.*, *Carlisle*, 129 S. Ct. at 1902 (recognizing the theories as incorporation by reference, assumption, agency, veil-piercing / alter ego, third-party beneficiary theories, and estoppel) (citing 21 Richard Lord, *Williston on Contracts* § 57:19 (4th ed. 2001)). The Rehabilitator never entered into a separate contractual relationship with Ernst & Young or indicated a willingness to arbitrate. The Rehabilitator cannot be bound under an agency theory because the arbitration agreement was entered into well before AIK's rehabilitation began. *Benjamin v. Pipoly*, 800 N.E.2d 50, 59 (Ohio Ct. App. 2003), stands for this proposition, holding that where the state-appointed receiver did not sign the agreement to arbitrate, it could not be enforced against her.

The court in *Benjamin* reasoned that a receiver "must have freedom of action to do those acts most beneficial in achieving her objectives." *Id.* at 58. Accordingly, the court held that a receiver

> may affirm or disavow the rights and obligations of the interest with which she is charged, and it would be inconsistent to compel arbitration against her when such an obligation predates her appointment.
>
> Thus we hold that when a liquidator is appointed by court order, as in the instant case, she is not automatically bound by the pre-appointment contractual obligations of the insurer.

Id. at 58–59.

The Kentucky Supreme Court has likewise articulated such a policy regarding a receiver's power to accept, modify, or reject private contracts to protect the public interest in the efficient and orderly rehabilitation of a workers' compensation insurer. *See Ky. Cent. Life Ins. Co. v. Stephens*, 897 S.W.2d 583, 587 (Ky. 1995) (recognizing the rehabilitator's police powers). This Court does not normally disturb a court's judgment on issues so heavily dependent on state law. *See Runyon v. McCrary*, 427 U.S. 160, 181 (1976).[11]

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[11] Additionally, in light of recent decisions from the Kentucky Supreme Court, any remand of this case will cause that court to consider whether Ernst & Young failed to appeal the circuit court's opinion in accord with the Kentucky Rules of Civil Procedure. *See North Fork Collieries, LLC v. Hall*, 322 S.W.3d 98, 101 (Ky. 2010) (recognizing, in a decision after this case, Civil Rule 65.07 as the appropriate method for appeal of decisions denying motions to compel arbitration when the Kentucky Arbitration Act is, as here, inapplicable). Ernst & Young filed their appeal under the Kentucky Arbitration Act, Ky. Rev. Stat.

The arbitration agreement is not enforceable because it is expressly subordinate to the mandates of the Kentucky Insurance Code, and that regulatory scheme, particularly the IRLL, provides the Franklin Circuit Court exclusive jurisdiction over this matter. Because such state-law issues would remain on remand regardless of this Court's disposition, the Court should deny the Petition.

CONCLUSION

Ernst & Young presents no compelling reasons for granting its Petition for Writ of Certiorari. Ernst & Young fails to demonstrate that the Kentucky Supreme Court's Opinion applying the McCarran–Ferguson Act is in conflict with a decision of this Court, a decision of a federal court of appeals, or a decision from any state court of last resort. *See* Sup. Ct. R. 10(b)–(c). Ernst & Young further fails to demonstrate that the Kentucky Supreme Court decided an important federal question that has not been settled by this Court. *See* Sup. Ct. R. 10(c). Ernst & Young does not even carry the significantly less strenuous burden of showing that the Kentucky Supreme Court abused its discretion in its method of applying federal law to enforce Kentucky insurance law, which would, in any event, constitute insufficient grounds to grant its Petition. *See* Sup. Ct. R. 10. Finally, even if this case did present the sort of federal question that would justify granting the Petition, and it does not, it would remain an inappropriate vehicle

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Ann. § 417.220, and Civil Rule 73.02. This state-law issue would remain on remand regardless of this Court's disposition and is another reason why the Court should deny the Petition.

for answering that federal question as a result of threshold issues of state law.

Accordingly, Respondent Sharon P. Clark respectfully requests that the Court deny the Petition.

Respectfully submitted,

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APPENDIX

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APPENDIX A

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION II

CIVIL ACTION NO. 04-CI-01067

[Filed December 8, 2005]

R. GLENN JENNINGS, IN HIS CAPACITY AS EXECUTIVE DIRECTOR KENTUCKY OFFICE OF INSURANCE	)
PETITIONER	)
V.	)
AIK COMP F/K/A ASSOCIATED INDUSTRIES OF KENTUCKY SELECTIVE SELF-INSURANCE FUND	)
RESPONDENT	)

FINDINGS OF FACT AND CONCLUSIONS OF LAW AND ORDER

This matter came on for hearing without intervention of a jury on October 11, 2005, pursuant to a Notice as approved by the Court given by the

Petitioner on or about September 28, 2005. The hearing was scheduled by the Court pursuant to KRS 304.33-160 on the request of the Rehabilitator to approve a plan of reorganization and a plan of assessment for AIK Comp f/k/a Associated Industries of Kentucky Selective Self-Insurance Fund, pursuant to KRS 304.33-160. The Rehabilitator was represented by Walter L. Sales and Justin D. Clark of Ogden Newell & Welch and by William J. Nold of the Office of Legal Services of the Commonwealth of Kentucky. The Trustees of AIK Comp were represented throughout these proceedings and at the hearing by Charles Greenwell and Charles Middleton of Middleton & Reutlinger. Approximately 500 AIK Comp group members intervened in this action, represented by approximately 60 different law firms. Exhibit 1 to these Findings of Fact and Conclusions of Law is a list of all of the law firms who were given notice of this hearing. Appearing in person at the October 11 hearing were the following lawyers and law firms representing their members: Janet Craig, Stites & Harbison; Greg Mitchell, Frost Brown Todd; David Hale, Reed Weitkamp Schell & Vice; Dandridge Walton, Hazelrigg & Cox; Frank Chuppe, Wyatt, Tarrant & Combs; Bradford Bollman, Schiller Osbourn & Barnes; Schuyler Olt, Pedley, Zielke, Gordinier & Pence; David Faughn, Miller, Griffin & Marks; and David Bratt. Also appearing at the hearing was an individual group member of AIK Comp; Art's Electric Company, and Carol Kolber and Chuck Milliner, representing various AIK Comp group members to observe the proceedings. Also appearing at the hearing was Alan Cobb, representing Kathy Baker, a former officer of AIK Comp. None of those appearing objected to the requested approval of the plan of reorganization or the assessment plan, except for David Faughn with

Miller Griffin & Marks (hereinafter referred to as the "MGM intervenors"). Despite notice of the proceedings none of the other intervenors appeared at the hearing, though all were given notice of the proceedings. No procedural objections to notice or to the conduct of the proceedings were heard or presented.

The MGM intervenors stated in open court that they did not object to the amount of the deficit as determined by the Rehabilitator, nor did they object to the method of allocating that deficit among the group members of AIK Comp, but objected to the following points:

- Jurisdiction of this Court;

- Constitutionality of Sections 50 and 51 of Senate Bill 86;

- Their joint and several liability for the deficit;

- Being subject to an interest penalty of 1% per month if they do not pay the assessment in the manner called for by the reorganization plan and the assessment plan;

- Being subject to pay attorneys' fees of the Rehabilitator for litigating and/or refusing to pay assessments;

- Not being released from joint and several liability and not enjoying the benefits of third party recoveries if they fail to pay in accordance with the assessment plan; and

- Being subject to a "show cause" procedure to collect assessments from them as opposed to requiring the filing of new lawsuits.

Witnesses called on behalf of the Petitioner were Ernest Dry, Special Deputy Rehabilitator; Joseph Pope, Special Deputy Rehabilitator; Shawna Ackerman of Pinnacle Actuaries, Inc.; Lee Groza of Mountjoy and Bressler; and Robert Glenn Jennings, Executive Director of the Office of Insurance and Rehabilitator of AIK Comp.

No intervenor called witnesses.

The hearing began at 10:00 a.m. on October 11, 2005 and concluded that same day at approximately 2:30 p.m. Following the conclusion of all testimony, Janet Craig of Stites & Harbison and Greg Mitchell of Frost Brown Todd spoke in favor of the reorganization plan and the assessment plan presented by the Rehabilitator. The MGM intervenors objected to the assessment and reorganization plans and were directed to file written objections within five (5) days of the close of the hearing and proposed findings of fact and conclusions of law were directed to be filed by counsel for the Rehabilitator within ten (10) days of the close of the hearing.

The Rehabilitator and Counsel for certain group members both filed Amended Proposed Findings of Fact and Conclusions of Law. The Trustees have filed Exceptions to the Petitioner's (Rehabilitator's) Amended Proposed Findings of Fact and Conclusions of Law. All filings have been reviewed and considered by the Court.

FINDINGS OF FACT

The participants:

1. The Petitioner, R. Glenn Jennings, is the duly appointed Executive Director of the Office of Insurance, Commonwealth of Kentucky since April 28, 2005, and the Court appointed Rehabilitator of AIK Comp pursuant to KRS 304.33-150.

2. AIK Comp is an unincorporated association of members who qualify as a workers' compensation self-insured group under Kentucky law and who associate jointly to self-insure their workers' compensation liabilities. KRS 342.350(4); KRS 304.50-010.

3. The trustees of AIK Comp are the trustees duly appointed by AIK Comp's sponsoring organization, AIK, Inc., formerly known as Associated Industries of Kentucky, Inc. ("AIK Inc.").

4. The intervenors are group members of AIK Comp, that is, employers in the Commonwealth of Kentucky who, between January 1, 1999 and February 28, 2005, were credited with earned premium paid to AIK Comp for workers' compensation liability self-insurance coverage. These group members filed applications for coverage with AIK Comp, and in so doing, agreed to be bound by the bylaws of AIK Comp (Rehabilitator's Exhibit 6), the indemnity agreement filed by AIK Comp with the then Kentucky Department of Workers' Claims. (Rehabilitator's Exhibit 8), and by Kentucky law.

JURISDICTION

5. Pursuant to KRS 304.33-040(1) the Petitioner has the authority to commence a delinquency or receivership proceeding against AIK Comp.

6. Pursuant to KRS 304.33-040(1) this Court has exclusive jurisdiction to entertain, hear and determine all matters in any way relating to AIK Comp's receivership, including all issues presented at the hearings before this Court, which are identified herein. The Court may issue any order, process or judgment necessary or appropriate to carry out the provisions of KRS 304, Subtitle 33.

HISTORY OF AIK COMP

7. AIK Comp has been in the business of being a group self-insurer for workers' compensation liabilities for employers in the Commonwealth of Kentucky since 1979. In order to have coverage for workers compensation liabilities with AIK Comp, an employer must also be a member of its sponsoring organization, AIK, Inc. (See Letter of April 24, 1979, ONW 039027-039030; part of Rehabilitator's Exhibit 9.)

8. Beginning in 1997, AIK Comp began discounting its premiums to its members. In 1999, according to an analysis performed by Special Deputy Rehabilitator Joseph Pope on a retrospective basis, AIK Comp went into a deficit position from an operations basis.

9. AIK Comp had its financial statements audited annually by outside certified public accountants. The audit reports for the years 1999 through 2002 reflects AIK Comp as having positive fund balances, as follows:

- For the year ending December 31, 1999, a fund balance of $11,664,477.00 (Rehabilitator's Exhibit 38T);

- For the year ending December 31, 2000, a fund balance of $11,384,565.00 (Rehabilitator's Exhibit 38U);

- For the year ending December 1, 2001, a positive fund balance of $6,532,221.00 (Rehabilitator's Exhibit 38U)[1];

- For the year ending December 1, 2002, a positive fund balance of $46,588.00 (Rehabilitator's Exhibit 38V).

10. In June, 2004, realizing that it was in a deficit position, AIK Comp attempted a remediation with the Office of Workers' Claims and informed its members of such. (Rehabilitator's Exhibit 2.)

11. Ultimately, the trustees of AIK Comp decided that they were unable to remediate and agreed to a rehabilitation under the auspices of the Executive Director of the Office of Insurance pursuant to KRS 304.33.040, -140, and -150. (Rehabilitator's Exhibit 3.)

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[1] The auditors later restated the fund balance for the year ending December 31, 2001 to $4,754,248.00 (Rehabilitator's Exhibit 38V).

PROCEEDINGS TO DATE

12. On August 3, 2004, Governor Fletcher issued Executive Order 2004-835, which transferred regulatory authority over group workers' compensation self-insured groups from the Office of Workers' Claims to the Office of Insurance. Accordingly, the AIK Comp trustees voluntarily entered and agreed to the placement of AIK Comp into rehabilitation (Rehabilitator's Exhibit 44; Petition for Rehabilitation filed August 5, 2004). The Rehabilitator at the time, Martin Koetters, appointed Ernest Dry and Joseph Pope as Special Deputy Rehabilitators pursuant to KRS 304.33-160(1). Both Pope and Dry have significant successful executive experience with insurers.

13. Shortly after this Court ordered rehabilitation, the Special Deputy Rehabilitators sent a notice (Rehabilitator's Exhibit 4) advising the AIK Comp group members of the rehabilitation and of the ways that members could communicate with the Special Deputy Rehabilitators who were now fully in charge of the management and operations of AIK Comp.

14. On October 14, 2004, the Special Deputy Rehabilitators sent a letter to all AIK Comp group members advising them, among other things, of the likelihood and imminent filing of an assessment plan. The assessment plan implemented in November, 2004 (the "Plan of Initial Assessment" or the "PIA") was based upon a deficit existing as of December 31, 2003 of approximately $60,000,000.00 as determined by James E. York, a financial examiner with York Consulting, Inc., who was retained by the Office of

Workers Claims to perform a financial examination. (Rehabilitator's Exhibit 11). Upon completion of the financial examination by Larry Shores with Shores Tagman & Company, certified public accountants, the deficit for 2003 was determined to be $63,415,926.00 (Rehabilitator's Exhibit 14). The AIK Comp group members were notified of PIA, as were the agents for these members.

15. In late November and early December, 2004, several group members intervened and filed a motion to dismiss the rehabilitation petition, arguing principally that group self-insurers, such as the members of AIK Comp, are not subject to regulation under the insurance laws by virtue of KRS 342.350(4), which slates in pertinent part that:

> Employers securing certification as group self-insurers are regulated by the administrative regulations drawn by the commissioner and are not to be in any way subject to the provisions of subsections (1), (2) and (3) of this section...

16. The intervenors who moved to dismiss also argued that because AIK Comp was a self-insurance fund, there was no technical transfer of risk such that AIK Comp could be deemed an insurer within the meaning of KRS 304.33-030(4) or KRS 304.1-040.

17. At a hearing on January 27, 2005, the Rehabilitator advised the Court and all parties of new legislation that was filed and would correct any potential jurisdictional defects. Thereafter, without objection, this Court did not rule on the Motions to Dismiss and directed the parties to mediation.

18. On March 1, 2005, Governor Fletcher signed Senate Bill 86, which amended the insurance and rehabilitation statutes and the workers compensation laws in a variety of ways pertinent to the instant matter. Most significantly, Senate Bill 86 amended KRS 342.350(4) to repeal the exemption for group self-insurers from regulatory oversight by the insurance laws of the State cited above. Second, Senate Bill 86 amended KRS 304, subtitle 33, specifically to include workers' compensation self-insurance groups covered persons subject to subtitle 33. Third, Senate Bill 86 was retroactive to August 1, 2004 and it confirmed Governor Fletcher's executive order transferring jurisdiction from the Office of Workers' Claims to the Office of Insurance.

19. Following the enactment of Senate Bill 86, the Rehabilitator moved for permission to amend his petition in light of Senate Bill 86 and that motion was granted. An Amended Petition was filed by the Rehabilitator and was ordered to be filed by this Court on March 15, 2005.

20. The mediation ordered by the Court at the January 27, 2005 hearing concluded and was at least partially successful by late March, 2005. As a result of that mediation, this Court entered an Order of April 7 requiring the Rehabilitator to file an assessment plan and a reorganization plan by June 15 and setting forth a procedural and discovery schedule leading to a hearing to determine whether this Court would approve the June assessment and reorganization plans. The Rehabilitator sent a notice of that Court Order to all AIK Comp group members in a letter dated April 8, 2005 (Rehabilitator's Exhibit 19B) and

posted the April 7 Order and the April 8 letter on AIK Comp's website.

21. In accordance with the Order of April 7, 2005, the Rehabilitator, on June 15, 2005, filed a new assessment plan based upon the total deficit of AIK Comp as of February 28, 2005. Additionally, the Rehabilitator filed a Reorganization Plan on June 15. The Plan of Initial Assessment filed on November 5, 2004 sought to recover assessments to fill a deficit as of December 31, 2003. The June 15 assessment sought assessments from group members to cover a deficit developed through February 28, 2005, the last day on which AIK Comp continued to provide workers compensation insurance coverage.

22. Additionally, the June assessment plan contained a methodology change from the Plan of Initial Assessment by allocating the deficit based on standard premium as opposed to allocating the deficit based on billed earned premium.

23. After the Rehabilitator filed the assessment plan and reorganization plan in June, 2005, both plans were posted on AIK Comp's website. Thereafter, intervenors representing several hundred group members and the Rehabilitator engaged in extensive discovery. On July 13, 2005, pursuant to the orders of this Court, the Rehabilitator gave notice to all group members of a hearing that was scheduled for September 14, 2005 on the Rehabilitator's request to approve the Assessment Plan and Reorganization Plan of June 15, 2005 and of the right of the group members to object if they wish to do so by intervening on or before July 29, 2005. (Rehabilitator's Exhibit 20.) That notice was sent by first class mail and was also

published in The Louisville Courier-Journal and The Lexington Herald-Leader. (Rehabilitator's Exhibit 21 & 22.)

24. The Court again ordered the parties to mediation immediately prior to the hearing of September 14. After two days of meetings, with the assistance of mediator, Michael Troop, the Rehabilitator and the other parties to the mediation reported on September 14 that they made significant progress and had reached tentative settlement. The settling intervenors were basically those intervenors who had participated in this proceeding and had complied with the pre-trial orders of this Court by filing witness and exhibit lists and responded to discovery. On September 23, 2005, the settling intervenors and the Rehabilitator confirmed that a settlement had been reached on acceptable modified terms of a reorganization plan and assessment plan which would be approved by Mr. Jennings as Executive Director of the Office of Insurance and as Rehabilitator of AIK Comp and would require this Court's approval.

25. This Court assigned October 11 for a hearing on the assessment plan and reorganization plan now being proposed by the Rehabilitator in accordance with the settlement reached between the Rehabilitator and the settling intervenors. On September 29, 2005 the Rehabilitator gave notice to all group members of the modified assessment plan and reorganization plan and of the hearing scheduled for October 11. (Rehabilitator's Exhibit 29). That notice was published in four major newspapers; The Louisville Courier-Journal, The Lexington Herald-Leader, The Paducah

Sun, and The Kentucky Post. (Rehabilitator's Exhibits 30, 31, 32, & 33).

26. On October 11, 2005, the hearing was held on the Rehabilitator's request to approve the assessment plan (the "2005 Assessment Plan") and reorganization plan (the "Modified Reorganization Plan") which are attachments to the Settlement Agreement (Rehabilitator's Exhibit 34A-34K). No AIK Comp member appeared to object to the assessment plan or the reorganization plan, or to the Settlement Agreement reached by the Rehabilitator with the settling intervenors, with the exception of the MGM intervenors.

27. The MGM intervenors did not offer any evidence; but reserved their right to object to their joint and several liability, and they have since joined in a Motion to Dismiss filed by the Stites intervenors and others challenging the constitutionality of Sections 50 and 51 of Senate Bill 86. The Rehabilitator has moved to strike the MGM notice of joinder on grounds that it is moot. The MGM intervenors also object to provisions of the assessment and reorganization plan which would require that they pay interest on unpaid assessments in the amount of 1% per month, that they pay the attorney's fees of the Rehabilitator in any proceeding to collect those assessments if the Rehabilitator is successful, and that they not participate in any fashion in the recovery of funds from third parties who may have caused the AIK Comp deficit. The MGM intervenors also object to the provisions of the 2005 Assessment Plan and Modified Reorganization Plan which allows the Rehabilitator to proceed against and to obtain a judgment against group members who refuse to pay the assessment by

a "show cause" procedure as opposed to the commencement of a new civil action. Finally, the MGM intervenors object to being excluded from an early release of joint and several liability if they do not pay their assessments timely in accordance with the assessment plan.

28. As to the joint and several liability claim, many of the group members have taken the position that they were induced to join or remain a member of AIK Comp by financial statements showing that AIK Comp enjoyed a surplus when in fact it was in a deficit position and also by virtue of the failure of AIK Comp's management to secure adequate aggregate excess insurance to "secure adequately unpredictable losses" in accordance with 803 KAR 25:026, § 7. The group members who object to joint and several liability take the position variously that either they were fraudulently induced to remain or to become a member of AIK Comp, or that AIK Comp engaged in a material breach of the underlying contract with the members. In either event, they argued that they should not be required to remain jointly and severally liable for the obligations of AIK Comp, and should be allowed to rescind the contract.

29. The Rehabilitator moved for Partial Summary Judgment on the joint and several liability issue, arguing that joint and several liability is a statutory and regulatory mandate, and that contractual defenses such as fraudulent inducement or material breach cannot serve as a defense to joint and several liability because many employers/group members would be unable to self-insure their own liabilities which would cause many injured workers to lose the statutory workers' compensation liability

coverage. Additionally, the Rehabilitator has taken the position that once an injured worker becomes a claimant, that injured worker then becomes a creditor of AIK Comp, and as an unincorporated association, all members of that association are liable for the properly incurred debts of the association. Finally, the Rehabilitator argues that the defense of rescission available to parties to a contract if they were fraudulently induced to enter into the contract or in the event there was a material breach in the contract is not available to the group members here under traditional contract law because: (1) the rights of third parties (injured workers) have intervened; and (2) group member's have not timely or effectively made the choice available to them (affirmance of the contract or rescission) or taken any other steps consistent with a realistic intent to disaffirm the contract and seek rescission.

30. In this connection, the Rehabilitator supported his Motion for Partial Summary Judgment with the affidavit of Special Deputy Rehabilitator, Ernest Dry, which confirmed that there were at least a couple hundred group members who were not locatable, and therefore, their injured workers would likely have no coverage in the event joint and several liability were not enforced against the remaining members. Dry also testified that no AIK Comp group member had asked or insisted that AIK Comp stop paying benefits to their own injured workers because that group member intended to cover its employees itself out of a desire to rescind the contract. According to Dry, AIK Comp has continued to provide workers' compensation coverage to all injured workers, and had not missed or failed to pay a single claim of an injured

worker who properly presented a claim for workers' compensation coverage.

31. The Court also notes that the indemnity agreement filed by AIK Comp with the Office of Workers' Claims pursuant to 803 KAR 25:026, § 3(f) (Rehabilitator's Exhibit 7) states that:

> The members of this fund do jointly and severally covenant and agree that they will pay any such award as would otherwise be a claim against the aforesaid surety bond or securities as soon as the same shall become payable under the laws under the state of Kentucky; and the group agrees to pay such assessments as may be ordered by the Commonwealth of Kentucky under Chapter 342 of the Kentucky Revised Statutes.

32. In that same Indemnity Agreement, it is also stated:

> That the members of said fund execute a covenant or agreement whereby in addition to the collateral just above mentioned, the fund and its members will jointly and severally covenant to assume and discharge, by payment, any lawful awards entered by the Board against any member of this group which award shall have been sustained by the Courts or an appeal by either party is taken.
>
> That the members of the fund execute a covenant or agreement whereby the fund and each member thereof would jointly and severally covenant and agree to pay premiums

> and assessments, based upon appropriate classifications and rates, into a designated cash reserve fund out of which lawful and proper claims and awards are to be paid, and further, that the group member would jointly and severally covenant and agree that there will be no disbursements out of this fund by way of dividends or distribution of accumulated reserves to the respected members, except at the direction of the trustees. (Rehabilitator's Exhibit 7).

33. This Indemnity Agreement was filed with the Office of Workers' Claims at the inception of the fund and incorporated by reference into every member's application for coverage that is made with AIK Comp. That AIK Comp membership application agreement states:

> That, by this reference, the terms and provisions of the Indemnity Agreement and/or amendments heretofore filed or which may hereafter be filed with the Kentucky Workers Compensation Board are hereby adopted, approved, ratified and confirmed by us; and further, I (we) agree to assume all the obligations set forth therein, including, but not limited, to our joint and several liabilities for payment of any lawful awards against any member of the fund; and in the event, I (we) fail to pay any premium or lawful assessment within thirty (30) days of the date the same shall be come due, I (we) will pay all costs of the collection thereof, including reasonable attorneys' fees. (Rehabilitator's Exhibit 8.)

34. In that same application, each AIK Comp group member agrees:

> To abide by the rules, regulations, and by-laws of the fund and to conform to the terms of the agreements they may enter into with any authorized service company as long as we remain a member of the fund.

35. The by-laws of AIK Comp (Rehabilitator's Exhibit 6) also confirms these undertakings. Article I, Section 6 of the by-laws stales that:

> Each member of the Fund, by their participation in the Fund, shall adopt and ratify these by-laws and other rules, regulations, and requirements provided by the Fund or imposed on the Fund by state or federal law or authorized by action of the trustees of the Fund.

36. Section 8 of the by-laws identifies the objectives of the fund:

> To formulate, develop and administer a program of self-insurance for the membership of the fund; to obtain lower costs of workers compensation and other insurance coverages; provide excess insurance coverage; and develop a comprehensive safety program; to perform any and all other functions necessary to have a cost effective workers compensation program. All the above mentioned activities shall be performed as agent and representative of the various participants of the fund.

37. According to the by-laws in Article 3, Section 1, the Board of Trustees of AIK Comp are granted the power to, "make additional assessments on a pro-rata basis to protect the financial integrity of the fund and to pay all claims against fund members."

38. On September 6, 2005 this Court sustained the Rehabilitator's motion for partial summary judgment finding as a matter of law that the AIK Comp group members were jointly and severally liable for the AIK Comp deficit.

THE SETTLEMENT AGREEMENT

39. The settling intervenors and the Rehabilitator entered into a Settlement Agreement on October 3, 2005. Attached to that Settlement Agreement (Rehabilitator's Exhibit 34) is the Modified Reorganization Plan and the 2005 Assessment Plan which the Rehabilitator proposes to implement and which the Rehabilitator seeks this Court's approval.

40. The Modified Reorganization Plan provides that the Rehabilitator shall operate and manage AIK Comp in a self run-off mode for the foreseeable future. While the goal of the reorganization is ultimately a capping of liability for the group members of AIK Comp, that can only occur in the near term if there is a transfer of assets and a reliable transferee willing to cap each member's liability. It was explained that a transfer of that nature, commonly referred to as a loss portfolio transfer (LPT), may not currently be economically feasible for two primary reasons: (1) assessments are needed to cover the liabilities of the fund which could last for 20-25 years, and (2) another few years of loss development will be

necessary to convince any potential transferee that a sufficiently precise and accurate prediction of AIK Comp's ultimate claims liability exists to justify a reasonably priced transfer.

41. To achieve the goal of capping member liability through a transfer and securing the payment of claims of injured workers for workers' compensation benefits, the Rehabilitator has proposed to collect an assessment as set forth in the 2005 Assessment Plan, and to manage AIK Comp in rehabilitation as efficiently and as economically as possible. As further set forth below, the 2005 Assessment Plan seeks to collect assessments from AIK Comp group members on a pro-rata basis in the amount of approximately $90,775,774.00. Eighty percent (80%) of that is anticipated to be collected through the assessment within sixty (60) days of the anticipated order of this Court.

42. The Modified Reorganization Plan calls for the collection of these assessments, and identifies a goal as releasing members from joint and several liability who promptly pay assessments as they come due with a combination of cash and callable notes. Though prompt payment is necessary, according to the Modified Reorganization Plan, provisions are made for hardship payment plans on a case-by-case basis. Additionally, members will be able to contest the calculation of individual assessments and other individualized objections they may have through an expedited proceeding conducted by this Court or by a special master/commissioner operating pursuant to this Court's orders.

43. On an ongoing basis, it is also anticipated that the group advisory committee which was established pursuant to this Court's order of April 7, 2005 will continue, and could expand or change as needed to facilitate the exchange of information between the group members and the Rehabilitator and as a forum for resolving concerns amicably, rather than through confrontation/litigation.

44. The 2005 Assessment Plan assesses the members for a deficit which is supported both by the actuarial loss reserve estimate prepared by Pinnacle Actuaries and an audit report for the year ending February 28, 2005 reflecting a deficit of $90,775,774.00. The Rehabilitator determined in hindsight that AIK Comp slid into a deficit position in 1999 from which it has not emerged. The deficit has grown each year. The Rehabilitator and Special Deputy Rehabilitators determined the amount of the deficit which can be fairly allocated for each year between 1999 and February 28, 2005. Members are assessed for their pro-rata portion of the deficit for each year between 1999 and 2005 that AIK Comp received earned premium from that member. If a member was credited with earned premium in 1999, but not thereafter, then that member only pays a pro-rata portion of the deficit allocable to 1999.

45. The Rehabilitator has also determined to pro rate each member's assessment based upon the difference between what the assessment would be if it were calculated according to standard premium and what it would be if calculated according to the billed earned premium. The PIA used the methodology of billed earned premium of each member in any particular year compared to the billed earned

premiums of all members of that year. Under the June 15, 2005 assessment plan, the Rehabilitator had used a calculation which added back into the formula the AIK Comp special discounts received by many of its members. That had the effect of causing members who received the greatest discounts to have a larger assessment than if their billed earned premium alone was used as a reference.

46. The compromise in the settlement agreement of using one-half of the AIK Comp special discount is fair and reasonable because it represents a balancing of all of the interests of all of the members. The Court finds that this compromise is fair because it takes into account the interests of the injured workers in making sure that their claims for workers' compensation benefits are satisfied, and it balances all of the interests of all AIK Comp group members.

47. Approximately one percent (1%) of AIK Comp group members had what is known as retrospectively rated policies which means that the premiums were calculated in the same way as fixed premium policies (including the AIK Comp special discounts), but that the actual premium paid by that group member would change according to that group member's particular claims experience. There was both a floor and a ceiling below and above which a member's premium could not fluctuate. Group members with retrospective premium policies will also be required to pay an assessment defined as the ratio of their audited written provisional premium plus one-half of the AIK Comp discount in relation to all member's audited earned premium plus one-half of all AIK Comp discounts given in that year, or the same ratio but decreased by that member's particular claims

experience, whichever is less. In that fashion, according to the Special Deputy Rehabilitators, the retrospective policy holder retains the benefit of their bargain while still remaining liable for a fair proportionate share of the deficit. The Court finds that this compromise is fair and takes into account the interests of the injured workers in ensuring the payments of their workers' compensation benefits are made, and a balancing of all of the interests of all AIK Comp members.

48. Pursuant to the 2005 Assessment Plan group members must pay eighty percent (80%) of their pro-rata share of the assessment in cash and execute contingent callable promissory notes for twenty percent (20%) of their pro-rata share of the assessment within sixty (60) days of mailing of the assessment package by the Rehabilitator unless they qualify for a hardship payment plan. In the event a member does not pay the assessment as required or does not pay any other indebtedness owed to AIK Comp, the Rehabilitator may move the Court to issue an Order directing the defaulting member to show cause why the Rehabilitator should not have judgment against that member for the amount assessed or otherwise owed. A member failing to appear and object upon a return date of an Order to show cause shall have a judgment entered against it together with costs and reasonable attorney's fees.

49. The evidence shows that the membership application signed by each AIK Comp group member provides that AIK Comp may recover its attorneys' fees in the event that it must commence legal action to compel the payment of a lawful premium or assessment.

50. Members who appear and object to the assessment will be entitled to a judicial determination (either by the Court or reference to a referee/special master commissioner) of the merits of their objection as to claims of an individualized nature. That recommendation will become final fifteen (15) days after mailing to the non paying member unless exceptions are filed within that period with the Court. Ultimately, the Court may enter appropriate orders and judgments in conformity with the recommendations of the referee or such other orders as the Court deems appropriate, including the awarding of costs and attorney's fees against the non-paying member. The Court finds that this compromise is fair and takes into account the interests of the injured workers in making sure that their claims for workers' compensation benefits are satisfied, and a balancing of all of the interests of all AIK Comp members. The Court further finds that the collection procedure set forth in the assessment plan affords members both procedural and substantive due process. Such procedures for the entry of a judgment against a policy holder are clearly recognized in KRS Chapter 304, Subtitle 33. The Court further finds that it is in the interests of insureds, creditors and the public in general that the Rehabilitator collect assessments and other indebtedness owed to AIK Comp by group members in a timely manner while protecting the due process rights of assessed members.

51. Members who do not pay their assessments in accordance with the assessment plan will not receive a release or compromise of their liability, are subject to costs, including the reasonable attorneys' fees and interest of one percent (1%) per month beginning on the 91st day following the mailing of the

invoice by the Rehabilitator. The evidence shows that each certificate of coverage sent by AIK Comp to each member contained a statement that an interest charge of 11/2% per month would be added to all overdue and unpaid premiums and assessments.

52. Upon collection of eighty percent (80%) of the total assessment by the Rehabilitator, or under other circumstances as described in the assessment plan, the Rehabilitator may release members who timely pay the assessment from joint and several liability to be replaced with pro-rata several liability. Each member's individual liability will be limited by their proportionate share of the deficit remaining to be collected; but there is no cap on the deficit itself subject to further assessments approved by the Court. The Rehabilitator may apply to the Court for permission to collect the callable notes under certain circumstances and may also seek additional assessments from all members if additional assessments are needed for reasons as specified in the assessment plan. For those members whose joint and several liability have been released, they will still be required to pay an assessment based upon their pro-rata share of whatever additional deficit is determined to exist by the Rehabilitator subject to the approval of this Court. The same will be true of members who do not pay timely but they will not receive a release from joint and several liability. For those members who do not pay in accordance with the assessment plan, their joint and several liability will not be released until and unless all liability of all group members is either transferred or released through a LPT or some other liability transferring mechanism.

53. Finally, the Court takes notice of the pendency of lawsuits commenced by the Rehabilitator, and other AIK Comp group members against various third parties whom may be liable to AIK Comp and/or its members for the deficits of AIK Comp. The parties have pledged in the Settlement Agreement and Modified Reorganization Plan to meet within thirty (30) days of October 11 to try to resolve some of the differences between the Rehabilitator and the AIK Comp group members who have filed lawsuits against some of the same parties. The 2005 Assessment Plan also provides that group members who fail to pay their assessment in accordance with the Assessment Plan will not gain the benefits of a recovery from the third parties if one is had either directly or by way of a reduction of the amount of the assessment owed.

54. The Court finds the method of allocating the deficit among the group members with fixed premium policies and those with retrospective premium policies is fair and reasonable and strikes a fair balance among the members while ensuring the financial integrity of AIK Comp in its ability to satisfy the claims of injured workers for workers' compensation benefits. The Court also finds that the other provisions of the Settlement Agreement, 2005 Assessment Plan and Modified Reorganization Plan as articulated above are also fair and reasonable, including without limitation: the potential for interest charges of one percent (1%) per month charged to non-paying AIK Comp group members, the potential to incur attorney's fees by AIK Comp members who force AIK Comp to expend legal fees to enforce their obligation to pay the assessment, collection procedures which include the show cause hearing for members who do not pay, the objection procedure allowing members to object to their

individual calculation of their assessment and to other individualized inquiries such as the short-rate premium dispute, the hardship provisions which allow a limited delay of the payment for certain qualifying members, and the provision dealing with penalties for group members who fail to pay.

55. The 2005 Assessment Plan calculates the deficit at $90,775,774.00 which is less than the amount the Rehabilitator set as the deficit in the June assessment plan. In the 2005 Assessment Plan the Rehabilitator could count on sufficient infusion of tangible assets (cash and interest bearing notes) that the Rehabilitator could discount reserves by four-and-one-half percent (4-1/2%), resulting in the lower deficit. The four-and-one-half percent (4-1/2%) discount rate is supported by the actuaries and is fair and reasonable.

56. If the Rehabilitator cannot collect the assessments contemplated by the 2005 Assessment Plan in a timely fashion the Rehabilitation will not have the investment income which enabled it to discount reserves. This will cause the deficit to increase. Hence, the Rehabilitator seeks approval of plans which create incentives for group members to pay assessments and disincentives for those who refuse to pay. The Court finds the balance of incentives and disincentives fair and reasonable because it provides cash for payment of claims, reduces the deficit, and enhances the likelihood of an LPT to cap the liability of all members.

CONCLUSIONS OF LAW

I.

1. This Court has exclusive jurisdiction over this delinquency proceeding to entertain, hear, or determine all matters in any way relating to this delinquency proceeding and the Court may issue any order, process, or judgment necessary or appropriate to carry out the provisions of KRS Chapter 304, Subtitle 33. KRS 304.33-040. KRS Chapter 304, Subtitle 33 must be literally construed to effect its purpose to protect the interests of insureds, creditors and the public generally and proceeding under its provisions are an integral aspect of the business of insurance and are of vital public interest and concern. KRS 304.33-010.

2. The proceedings authorized under KRS Chapter 304, Subtitle 33 may be applied to AIK Comp as a workers' compensation self-insured group. KRS 304.33-020(10) to (11).

II.

3. AIK Comp's financial condition is to be measured in accordance with generally accepted accounting principles (GAAP). The Executive Director of the Office of Insurance, the Rehabilitator, his Special Deputy Rehabilitators, the actuaries (Taylor Walker and Pinnacle) and accountants; (Shores Tagman and Mountjoy and Bressler) have complied with those accounting procedures in their analysis of AIK Comp's financial condition.

III.

4. The Executive Director determined and the Court concludes that AIK Comp was in such condition that the further transaction of business would be hazardous to its policyholders, creditors, and the public. Further, the Court finds that two-thirds of the Board of Trustees of AIK Comp consented to the Rehabilitation. Accordingly the grounds for rehabilitation exist. KRS 304.33-140(1)(f) and (m).

5. All AIK Comp group members, policyholders, and other interested persons received adequate notice of the 2005 Assessment Plan, the Modified Reorganization Plan, and Settlement Agreement, and of the hearing on the 2005 Assessment Plan and Modified Reorganization Plan commencing on October 11, 2005, and were awarded a full, fair and complete opportunity to be heard at the hearing with respect to the Executive Director's plans.

IV.

6. Constitutional challenges to Senate Bill 86 based upon the alleged invalidity of Sections 50 and 51 of that statute relating to the confirmation of the Executive Order under which AIK Comp was originally placed into rehabilitation and the retroactivity of Senate Bill 86 are moot. Senate Bill 86 was signed into law by Governor Fletcher on March 1, 2005 as emergency legislation, effective immediately. Section 50 of Senate Bill 86 ratified the Governor's executive order which transferred enforcement authority over workers compensation group self-insured groups from the Office of Worker' Claims to the Office of Insurance. Section 51 of Senate Bill 86

made the legislation specifically retroactive to August 4, 2004 when the Governor issued his executive order and AIK Comp was placed in rehabilitation.

7. The Rehabilitator amended the petition for rehabilitation effective March 15, 2005. The Amended Verified Petition replaced the previous Verified Petition. Under *Schwindel v. Meade County*, 113 S.W. 3d 159 (Ky. 2003), Kentucky Courts interpret CR 15 and the Federal Rule of Civil Procedure 15 identically. As such and pursuant to analogous federal case law, the filing of the Amended Verified Petition was the equivalent of filing a new action. *Morelan vs. University Guaranty Life Insurance Company*, 298 F. 3d 609, 617 (7th Cir. 2002); *Wellness Community-National v. Wellness House*, 70 F. 3d 46, 49 (7th Cir. 1995). This Court has jurisdiction to maintain this action under SB 86.

8. Furthermore, the Court finds SB 86 to be constitutional, retroactive remedial legislation due to the express language contained therein. *Kentucky Insurance Guaranty Association v. Jeffers*, 13 S.W. 3d 606 (Ky. 2000). SB 86 did not constitute improper special legislation or interfere with vested rights. *Kentucky Industrial Utility Customers v. Kentucky Utilities Co.*, 983 S.W. 2d 493 (Ky. 1998); *Hayes v. State Property and Buildings Commission*, 731 S.W. 2d 797 (Ky. 1987); *City of Paris v. Kentucky Utilities Co.*, 133 S.W. 2d 559 (Ky. 1939).

V.

9. AIK Comp is an unincorporated association, formed for the purpose of incurring and covering workers' compensation liabilities for its members in

accordance with its by-laws and applicable statutes and regulations. Members of AIK Comp are jointly and severally liable for all of the workers' compensation liabilities incurred by AIK Comp. *Jim Host and Associates, Inc. v. Sharp,* 639 S.W. 2d 784 (Ky. App. 1982); and *ING et al. v. Liberty National Bank,* 216 Ky. 467, 287 S.W. 2d 960 (Ky. App. 1926).

10. Moreover, Kentucky requires employers who wish to self insure their worker's compensation liabilities through a group self insurance fund to be jointly and severally liable for those obligations. *See* 803 KAR 25:026, Section 3 interpreting KRS 342.350(4). Contract defenses such as fraud in the inducement or material breach do not vitiate the statutory and regulatory responsibility of joint and several liability which the AIK Comp members have for the worker's compensation liabilities of AIK Comp. *Southwest Adminsitrators, Inc. v. Rozay's Transfer,* 791 F. 2d 769 (9th Cir. 1986). In any event, no AIK Comp member can rescind the contract because none have made any effort to place AIK Comp back into the status quo existing prior to the time when the member in fact joined. *Ruffner v. Ridgely,* 81 Ky. 165, 1883 WL 7819 (Ky. App. 1883); *In re Sallee,* 286 F.3d 878, 889-890 (6th Cir. 2002); Samuel Williston, 12 *Williston on Contracts,* Section 1460 (Walter H.E. Jeger, Editor, 3rd Edition, 1970), (contract may only be rescinded upon a tender of any consideration received is a general principle of law).

VI.

11. The assessment methodology represents a balance of conflicting interests and is a fair and reasonable method of curing the deficit and allocating

it among the group members of AIK Comp. The 2005 Assessment Plan does not violate the terms of the AIK Comp by-laws, indemnity agreement and membership application, and is consistent with applicable statutes and regulations. The Executive Director has not abused his discretion in adopting the assessment plan and the reorganization plan that were part of the Settlement Agreement reached with the settling intervenors.

12. The MGM intervenors' objection to being subject to attorney's fees in the event the Rehabilitator must commence legal action to collect assessments is not well founded. KRS 304.33-060 allows the Rehabilitator to seek attorney's fees incurred in pursuing litigation in any proceeding under KRS 304, Subtitle 33. Moreover, all AIK Comp members agreed when they became members of AIK Comp to pay reasonable attorneys' fees incurred by AIK Comp if AIK Comp were required to enforce its right to collect past due premiums and assessments. Accordingly, the Rehabilitator has the right to seek, and therefore to agree to seek attorney's fees and expenses incurred in pursuing litigation in any proceeding under KRS 304, Subtitle 33. The Court retains the right in appropriate cases to grant or deny an application for attorney's fees and expenses, and notes that currently no such specific request is pending.

13. It is well within the discretion of the Rehabilitator to assess interest against members who do not pay the assessment. Failure to collect interest will in fact cause the deficit to increase. AIK Comp group members agreed to pay interest at the rate of one and one-half percent (1-1/2%) per month on any unpaid premiums or assessments in their certification

of coverage the member receives from AIK Comp. Accordingly, it is fair and reasonable for the Rehabilitator to collect one percent (1%) per month.

14. Determining whether there has been a due process violation, Kentucky courts apply a test found in *Matthews v. Eldridge,* 424 U.S. 319, 333-35 (1976), which requires consideration of the private interest that will be affected by the official action; the risk of an erroneous deprivation of such interest with the procedures used; the probable value of additional or substitute procedural safeguards; and the government's interest any additional procedural requirement would entail. See *Division of Driver Licensing v. Bergman,* 740 S.W.2d 948, 951 (Ky. 1987). The Kentucky Court of Appeals in *Masood v. Kentucky Board of Medical Licensure,* 2005 WL 195363 (Ky. App. 2005) reviewed whether Dr. Masood's constitutional right to due process was violated by the trial court's review of KRS 311.571(8). Because the licensing statute involved there provided for a formal hearing pursuant to a show cause order this satisfied the *Eldridge* element of an additional safeguard of due process. See also *McGarry v. State,* 496 So. 2d 138 (Fla. 1986) where the court held that a show cause hearing was an adequate procedural safeguard for a member of an unincorporated association who was ordered to make restitution. Accordingly, the court concludes that the show cause procedure in the 2005 Assessment Plan contains adequate procedural and substantive safeguards for the protection of the constitutional due process rights which the MGM intervenors claim are missing from the assessment plan.

15. Moreover, in *Scott v. Lloyds of America of San Antonio,* 11 F.Supp. 787, 790 (W.D.Tex. 1935),

members of an unincorporated insurance association licensed under state law is subject to the control of insurance authorities. The association's attorney was designated by law to accept service of process and could bind association members in issuance of insurance contracts. The association was therefore suable in its collective name and members were bound by the judgment rendered against them in that name. Kentucky case law is consistent with that principle. *Jim Host & Associates, Inc. v. Sharp*, 639 S.W.2d 784, 785 (Ky. App. 1982). See also *Maher v. Zapata Corporation*, 714 F.2d 436 (5th Cir. 1983), where the rights of shareholders in the derivative action could be finally determined in a fairness hearing on a settlement with a show cause order. Hence, the show cause provisions of the assessment plans for members who fail to pay are reasonable and within the sound discretion of the Executive Director to implement.

16. See also *Ballesteros v. New Jersey Property Liability Insurance Guaranty Association*, 530 F. Supp. 1367 (D. NJ. 1982) where the Court held that due process was not offended when a policyholder's rights under their insurance policy were terminated without service of process where the policyholder was notified of the cancellation of his policy by the receiver by first class mail.

17. The Executive Director also proposes to release members who pay their assessment in a timely fashion pursuant to the 2005 Assessment Plan from joint and several liability and replace that joint and several liability with a *pro rata* several liability. The Executive Director also proposes that members who do not pay their assessments in a timely fashion according to the assessment plan will not have that

joint and several liability released until and unless there is a transfer of the liabilities and assets from AIK Comp to a third-party who can then release that liability for all. The Executive Director has "broad discretion in his efforts to rehabilitate the company," and KRS 304.33-160(2) "provides that as rehabilitated the commissioner may take such action as deemed necessary or appropriate to reform or revitalize the insurer. Full powers are granted to deal with the property and business of the insurer." *Minor v. Stephens,* 898 S.W.2d 71, 80 (Ky. 1995).

18. In this case, it is vital to the success of AIK Comp's rehabilitation that it receive a prompt and timely infusion of cash. This is necessary to provide financial integrity for the payment of workers' compensation claims for the benefit of injured workers and will also benefit the entire population of AIK Comp group members who will be better served the sooner the Rehabilitator can arrange for a LPT or some other form of risk capping transfer. Moreover, the public interest will be served in ensuring that workers' compensation claimants do not become wards of the state, and in maintaining a strong and reliable market for workers' compensation group self-insurance. Accordingly, it is within the discretion of the Executive Director to provide incentives for the timely payment of assessments and to withhold certain benefits from members who compromise the ability of the rehabilitator to achieve the goals outlined above.

19. Traditional contract notions and other contract rights are not inviolate in the context of a rehabilitation of an insurer. As stated in *Minor v. Stephens, supra,*

> "Neither the insurance company nor policyholders have inviolate rights that characterize ordinary private contracts. The policyholders' contracts as well as others with interest in the company, are subject to a reasonable exercise of state police power."

Accordingly, the Executive Director as Rehabilitator is operating within his authority in adopting a plan which conditions the release of joint and several liability to be replaced with *pro rata* several liability upon timely compliance with the assessment plan.

20. For the same reasons, the Executive Director as Rehabilitator is operating well within his discretion in recommending that any third-party recoveries from those who might be ultimately determined to have caused the deficit at AIK Comp benefit only those members who timely pay their assessments in accordance with the assessment plan.

21. The Court has made no final and binding determination of the cause of the AIK Comp deficit, and these findings of fact and conclusions of law should not be used or construed to determine the cause of the AIK Comp deficit or who was responsible for causing that deficit.

22. The Executive Director, as rehabilitator, has the power and duties set forth in KRS 304.33-160.

23. The Modified Reorganization Plan and the 2005 Assessment Plan which was the subject of the hearing on October 11, 2005 is approved and the

Rehabilitator shall commence to carry out the clarification and implement both.

24. The Modified Reorganization Plan and the 2005 Assessment Plan are subject to modification and clarification through further orders of the Court.

Wherefore, the Rehabilitator is ordered to proceed with implementation of the Modification Reorganization Plan and the 2005 Assessment Plan consistent with the Findings and Conclusions herein.

SO ORDERED, this 8 day of December, 2005.

/s/ William L. Graham
William L. Graham
Franklin Circuit Court
Division II

APPENDIX B

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION II

CIVIL ACTION NO. 05-CI-455

[Filed March 29, 2005]

MARTIN J. KOETTERS, EXECUTIVE DIRECTOR KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP

PLAINTIFF

V.

ERNST & YOUNG LLP

Serve: Any partner pursuant to CR 4.04(4), at
ERNST & YOUNG LLP
400 W. Market Street
Suite 2100
Louisville, KY 40202

DAVID S. MEYER
1900 Scripps Center
312 Walnut Street
Cincinnati, OH 45202

Serve: Secretary of State
152 State Capitol
700 Capitol Avenue
Frankfort, KY 40601

STEPHEN P. LATTANZIO
3555 Veteran's Memorial Highway
Ronkonkoma, NY 11779

Serve: Secretary of State
152 State Capitol
700 Capitol Avenue
Frankfort, KY 40601

ACTUARIAL & TECHNICAL
SOLUTIONS, INC.
3555 Veteran's Memorial Highway
Ronkonkoma, NY 11779

Serve: Secretary of State
152 State Capitol
700 Capitol Avenue
Frankfort, KY 40601

And

JOHN and JANE DOES, all unknown
actuaries and accountants against whom
AIK Comp may have a cause of action and
who may be responsible for damages
alleged herein

DEFENDANTS

*** *** ***

VERIFIED COMPLAINT

Plaintiff, Martin J. Koetters, Executive Director Kentucky Office of Insurance as Rehabilitator of AIK Comp, for and on behalf of AIK Comp ("Plaintiff"), in person and by counsel, for his Verified Complaint against Defendants, Ernst & Young LLP, Stephen P. Lattanzio, Actuarial & Technical Solutions, Inc., and John and Jane Doe defendants, states as follows:

I. JURISDICTION AND VENUE

1. This court has jurisdiction because the amount in controversy exceeds the minimum threshold for the jurisdiction to be invoked, because Defendants were at all times engaged in business in the Commonwealth of Kentucky, because the claims set forth herein arise out of Defendants' tortious and other conduct within the Commonwealth, and because the Rehabilitator brings this action pursuant to authority granted him under KRS Chapter 304, Subtitle 33.

2. Venue of this action is properly in the Franklin Circuit Court pursuant to KRS Chapter 304, Subtitle 33.

II. THE PARTIES

3. Plaintiff is the Executive Director of the Kentucky Office of Insurance. By orders of the Franklin Circuit Court, Division II, in Case No. 04-CI-01067, Plaintiff was appointed and continues to serve as Rehabilitator of AIK Comp with the authority to bring this action under the provisions of KRS Chapter 304, Subtitle 33.

4. AIK Comp is an unincorporated association and a group self-insurance fund as authorized by KRS Chapter 342. AIK Comp consists of employers throughout the Commonwealth of Kentucky who have agreed to jointly and severally pool their workers' compensation liabilities.

5. Defendant Ernst & Young LLP ("E&Y"), is a general partnership registered as a limited liability partnership in the state of Delaware, with its principal office located at 5 Times Square, New York, New York 10036-6530. E&Y is qualified to and does transact business in the Commonwealth of Kentucky. Certain partners of E&Y are residents in and citizens of the Commonwealth of Kentucky. E&Y served as the auditors for AIK Comp from 1998 through 2003, and issued opinions on financial statements, including, but not limited to, an estimate of the loss reserves of AIK Comp for each of those years, with the exception of 2003. Additionally, E&Y prepared AIK Comp's tax returns and other reports as required by Generally Accepted Auditing Standards ("GAAS"), and provided other consulting services as AIK Comp requested.

6. Defendant David S. Meyer ("Meyer") is a partner of E&Y. Meyer provided professional auditing services to AIK Comp from 1998 through 2003. Meyer has engaged in business within the Commonwealth of Kentucky and holds himself out individually as qualified to provide auditing and related services.

7. Defendant Actuarial & Technical Solutions, Inc. ("A&T") is an actuarial firm incorporated under the laws of the State of New York with its principal offices located in the State of New York, and has appointed the Kentucky Secretary of State as its agent

for service of process within the Commonwealth of Kentucky. AIK Comp retained A&T to provide professional actuarial services. A&T provided professional actuarial services to AIK Comp through and including the calendar year 2003. Those professional services included, but were not limited to, the issuance of actuarial opinions, reserve studies, rate studies and other legally required services.

8. Defendant Stephen P. Lattanzio ("Lattanzio") is and at all relevant times was the chairman and Chief Executive Officer of A&T. Lattanzio has engaged in business within the Commonwealth of Kentucky and holds himself out individually, and holds out A&T, as qualified to provide actuarial and related services. Lattanzio, together with A&T, provided professional actuarial services to AIK Comp through the calendar year 2003.

9. The John and Jane Doe defendants (the "Doe defendants") represent all unknown actuaries and accountants against whom AIK Comp may have a cause of action. The Doe defendants also represent those partners at E&Y who are at this time unknown and against whom AIK Comp may have a cause of action.

III. ALLEGATIONS

10. The Franklin Circuit Court, on petition by Martin J. Koetters, Executive Director Kentucky Office of Insurance, placed AIK Comp in rehabilitation by an order entered August 5, 2004.

11. The Franklin Circuit Court ordered Plaintiff, as Rehabilitator of AIK Comp, "to immediately take

possession and control of all the assets, property, books, accounts, documents, and other records of AIK Comp, wherever located, and regardless of whose custody or control they may be found..." Accordingly, Plaintiff took possession of all known assets, including causes of action that AIK Comp could have maintained in its own name.

12. Pursuant to KRS Chapter 304, Subtitle 33, Plaintff has the authority to bring civil actions on behalf of AIK Comp against "any officer, manager, agent, employee, or other person" whom the rehabilitator has reason to believe engaged in "tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer [AIK Comp]."

13. Since August 5, 2004, financial statements have been prepared and audited for the year ending December 31, 2003 which reveal a balance sheet deficit of over $60,000,000, and certain members of AIK Comp have been assessed accordingly.

14. Financial statements for the year ending December 31, 2004 are being prepared which, upon information and belief, will reveal that the deficit will substantially increase, thereby necessitating additional assessments upon members.

15. Pursuant to KRS 342.340, each employer in the Commonwealth of Kentucky is required either to insure its workers' compensation liability or provide satisfactory proof of its financial ability to assume such liability.

16. The Commonwealth of Kentucky has permitted employers to use as an alternative to

purchasing insurance in the traditional marketplace the ability to participate in a group self-insurance fund authorized under KRS 342.350(4).

17. Group self-insurance funds such as AIK Comp must file statements of financial condition, audited by certified public accountants, on an annual basis. The financial statement required to be filed by self-insurance groups must include "an actuarial opinion by a member or fellow of the Casualty Actuarial Society and a supporting reserve study regarding reserves for claims and expenses associated therewith." KRS 342.347(2).

18. From 1998 through 2002, E&Y and Meyer were responsible for the audit of the statement of financial condition of AIK Comp that was required to be filed pursuant to KRS 342.347. E&Y served as the independent auditor for AIK Comp and was responsible for, and did in fact audit and issue opinions on, all financial statements that AIK Comp was required to file with regulatory agencies, including taxing authorities, which AIK Comp used and relied upon in marketing its insurance policies to its members and potential members.

19. Defendants A&T and Lattanzio, from 1997 through 2002, were responsible for, and did in fact prepare, actuarial opinions and the supporting reserve studies regarding reserves for claims and expenses incurred by AIK Comp that were relied upon in the preparation of the financial statements, including those described above, and which were required to be filed pursuant to KRS 342.347. AIK Comp relied upon the actuarial opinions and reserve studies prepared by the Defendants A&T and Lattanzio in the preparation

of other financial statements that AIK Comp was required to file with regulatory agencies and authorities. AIK Comp further relied upon these opinions and reserve studies in soliciting and marketing to its members.

20. Defendants A&T and Lattanzio were responsible during this time period for preparing premium rate studies and making recommendations to AIK Comp regarding premium rate adequacy for policies issued by AIK Comp.

21. AIK Comp relied upon all the foregoing opinions and studies prepared by Defendants to establish the premiums for the insurance policies sold and marketed to AIK Comp's members.

22. From 1997 through 2002, Lattanzio and A&T, inter alia, consistently and negligently underestimated the anticipated losses due to claims incurred or to be incurred by AIK Comp resulting in AIK Comp establishing inadequate reserves to pay for those claims.

23. The financial statements audited and opined upon by E&Y and Meyer from 1998 through 2002 were inaccurate and materially misleading because, inter alia, they significantly and materially understated known claims and claims incurred, but not reported, and thus significantly and materially misstated AIK Comp's financial position as having a positive surplus. In fact, AIK Comp had a substantial deficit.

24. In auditing the financial statements from 1998 through 2002, and in providing unqualified audit opinions for those statements which reflected a surplus

for AIK Comp, E&Y and Meyer overlooked and/or ignored historical data, loss trends, and current events, and E&Y and Meyer accepted actuarial assumptions and conclusions that they knew, or should have known, were erroneous.

25. AIK Comp, in reliance upon E&Y, Meyer, Lattanzio, and A&T, set premiums that were inadequate. The premiums were based upon A&T's and Lattanzio's failure to properly calculate real and potential claims. The inadequate premiums charged to members were also based upon E&Y's and Meyer's failure to exercise proper care in the auditing of AIK Comp's financial statements. These failures by E&Y, Meyer, A&T, and Lattanzio caused AIK Comp to report to its members and to the Office of Workers' Claims that it was more financially sound than it really was. Defendants' negligence and misrepresentations regarding the financial soundness of AIK Comp misled regulators, the public, and AIK Comp's members, and delayed effective remedial measures from being taken that could have avoided rehabilitation.

IV. CAUSES OF ACTION

COUNT I – NEGLIGENCE AGAINST E&Y

26. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

27. E&Y provided professional services to AIK Comp in the course of their business to provide accurate and reliable auditing advice and services to AIK Comp.

28. E&Y received compensation and/or remuneration for those services provided to AIK Comp.

29. E&Y violated applicable auditing standards and was otherwise negligent in auditing AIK Comp's financial statements by overlooking, ignoring, or failing to consider historical data, loss trends, and current events and by further accepting actuarial assumptions and conclusions that it knew or should have known were erroneous.

30. E&Y owed a duty of care and prudence to AIK Comp in performing its audits in accordance with GAAS and accepted industry standards to make sure that the statements of financial condition that it certified for AIK Comp were in accordance with Generally Accepted Accounting Principles ("GAAP") and accepted industry standards. E&Y failed to exercise the care and prudence that it owed to AIK Comp, and its failure to exercise the care and prudence that it owed AIK Comp was a substantial factor in causing AIK Comp to suffer losses and other damages in an amount to be proven at trial.

31. E&Y's negligence in auditing AIK Comp's financial statements misled the Kentucky Office of Workers' Claims with respect to the financial condition of AIK Comp. As a result, remedial or other regulatory actions which could have been taken to salvage and save AIK Comp, thereby reducing the costs of assessment and rehabilitation incurred once AIK Comp was placed into rehabilitation, were not taken.

32. Upon information and belief, E&Y regularly audits the financial statements of insurers regulated by various regulatory agencies in the Commonwealth

of Kentucky and other states. Accordingly, E&Y knew or should have known that the information contained in the audited financial statements was misleading, deceptive, and/or inaccurate.

33. As a result of E&Y's negligence as described above in misleading the Kentucky Office of Workers' Claims, and the members of AIK Comp, AIK Comp has been damaged in an amount to be proven at trial.

COUNT II – NEGLIGENCE AGAINST MEYER

34. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

35. Meyer provided professional services to AIK Comp in the course of his business to provide accurate and reliable auditing advice and professional services to AIK Comp.

36. Meyer received compensation and/or remuneration for those services provided to AIK Comp.

37. Meyer violated applicable auditing standards and was otherwise negligent in auditing AIK Comp's financial statements by overlooking, ignoring, or failing to consider historical data, loss trends, and current events and by further accepting actuarial assumptions and conclusions that it knew or should have known were erroneous.

38. Meyer owed a duty of care and prudence to AIK Comp in performing his audits in accordance with GAAS and accepted industry standards to make sure that the statements of financial condition that he

certified for AIK Comp were in accordance with GAAP and accepted industry standards. Meyer failed to exercise the care and prudence that he owed to AIK Comp, and his failure to exercise the care and prudence that he owed AIK Comp was a substantial factor in causing AIK Comp to suffer losses and other damages in an amount to be proven at trial.

39. Meyer's negligence in auditing AIK Comp's financial statements misled the Kentucky Office of Workers' Claims with respect to the financial condition of AIK Comp. As a result, remedial or other regulatory actions which could have been taken to salvage and save AIK Comp, thereby reducing the costs of assessment and rehabilitation incurred once AIK Comp was placed into rehabilitation, were not taken.

40. Upon information and belief, Meyer regularly audits the financial statements of insurers regulated by various regulatory agencies in the Commonwealth of Kentucky and other states. Accordingly, Meyer knew or should have known that the information contained in the audited financial statements was misleading, deceptive, and/or inaccurate.

41. As a result of Meyer's negligence as described above in misleading the Kentucky Office of Workers' Claims, and the members of AIK Comp, AIK Comp has been damaged in an amount to be proven at trial.

COUNT III – NEGLIGENT MISREPRESENTATION AGAINST E&Y

42. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

43. E&Y owed AIK Comp a duty, inter alia, to ensure that its audits complied with GAAS and accepted industry standards.

44. E&Y breached this duty by negligently making false and misleading statements and omissions upon which AIK Comp directly or indirectly relied, and which reliance resulted in significant economic losses.

45. As a result of E&Y's negligent misrepresentation, AIK Comp has been damaged in an amount to be proven at trial.

COUNT IV – NEGLIGENT MISREPRESENTATION AGAINST MEYER

46. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

47. Meyer owed AIK Comp a duty, inter alia, to ensure that his audits complied with GAAS and accepted industry standards.

48. Meyer breached this duty by negligently making false and misleading statements and omissions upon which AIK Comp directly or indirectly

relied, and which reliance resulted in significant economic losses.

49. As a result of Meyer's negligent misrepresentation, AIK Comp has been damaged in an amount to be proven at trial.

COUNT V – NEGLIGENCE AGAINST LATTANZIO AND A&T

50. Plaintiff reiterates, restates and incorporates by reference all of the allegations contained in the preceding paragraphs of this Complaint.

51. Lattanzio and A&T provided actuarial and other services to AIK Comp, including, but not necessarily limited to, premium rate studies and recommendations about the adequacy of premiums. Lattanzio and A&T received compensation and/or remuneration for the services provided to AIK Comp.

52. Lattanzio and A&T were negligent in providing actuarial opinions and reserve studies to support the financial statements of AIK Comp for the years 1997 through 2002.

53. Lattanzio and A&T were contractually and professionally required to exercise care and prudence in the preparation of the reserve studies and the actuarial opinions to support the financial statements. Lattanzio and A&T failed to exercise the care and prudence their contract and profession required of them and, as a result, was a substantial factor in causing AIK Comp to suffer damages in an amount to be proven at trial.

54. Lattanzio and A&T knew or should have known that the claims incurred would be greater than they had estimated and, as a consequence, the loss reserves should have been much higher than were established.

55. The failure by Lattanzio and A&T to properly estimate claims and set loss reserves caused AIK Comp to misstate its financial condition to the Kentucky Office of Workers' Claims, the public, and to AIK Comp's members. The misleading financial statements to which A&T and Lattanzio contributed caused a delay in remediation or other remedial efforts that could have reduced the assessments required of AIK Comp members and stalled, and perhaps prevented, the need for rehabilitation and its associated costs.

56. As a result of Lattanzio's and A&T's negligence, AIK Comp has suffered damages in an amount to be proven at trial.

WHEREFORE, Plaintiff demands as follows:

1. Judgment against Defendants jointly and severally for monetary damages in an amount in excess of this Court's jurisdictional limits;

2. any and all equitable relief to which AIK Comp may appear properly entitled;

2. attorneys' fees and all costs herein expended;

3. all appropriate interest;

4. trial by jury on all issues so triable; and,

5. all further relief to which AIK Comp may appear entitled.

Respectfully submitted,

/s/ Walter L. Sales
Walter L. Sales
Douglas C. Ballantine
Justin D. Clark
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Counsel for Plantiff

VERIFICATION

STATE OF KENTUCKY
COUNTY OF FRANKLIN

I, Martin J. Koetters, Executive Director Kentucky Office of Insurance as Rehabilitator of AIK Comp, for and on behalf of AIK Comp, hereby verifies that the factual allegations set forth in the foregoing Complaint are to the best of my knowledge true and correct.

/s/ Martin J. Koetters March 28, , 2005
Martin J. Koetters, Executive Director
Kentucky Office of Insurance as
Rehabilitator of AIK Comp, for
and on behalf of AIK Comp,
Affiant

SWORN to and SUBSCRIBED before me this 28 day of March, 2005.

My commission expires: 10-28-06.

/s/ Jeff Henderson
NOTARY PUBLIC, STATE AT LARGE, KY

APPENDIX C

Ky. Rev. Stat. Ann. § 304.33-150 Rehabilitation orders.

(1) Appointment of rehabilitator. An order to rehabilitate the business of a domestic insurer, or an alien insurer domiciled in this state, shall appoint the commissioner and his or her successors in office rehabilitator and shall direct the rehabilitator forthwith to take possession of the assets of the insurer and to administer them under the orders of the court. The filing or recording of the order with any county clerk in the state shall impart the same notice as a deed, bill of sale, or other evidence of title duly filed or recorded with that county clerk.

(2) Any order issued under this section shall require accountings to the court by the rehabilitator. Accountings shall be at such intervals as the court specifies in its order, but no less frequently than semiannually. Each accounting shall include a report concerning the rehabilitator's opinion as to the likelihood that a plan under KRS 304.33-160(5) will be prepared by the rehabilitator and the timetable for doing so.

(3) Anticipatory breach. Entry of an order of rehabilitation shall not constitute an anticipatory breach of any contracts of the insurer, and it shall not be grounds for

revocation or cancellation of any contracts of the insurer.

Ky. Rev. Stat. Ann. § 304.50-110 Statement of financial condition -- Contents.

(1) In addition to reports required under KRS 304.50-060, each workers' compensation self-insured group shall file with the commissioner an annual statement of financial condition audited by an independent certified public accountant on or before one hundred and twenty (120) days from the end of the group's fiscal year for the immediately preceding fiscal year. The annual financial statement shall be on a form approved by the commissioner and in accordance with generally accepted accounting principles.

(2) The annual financial statement shall include actuarially appropriate reserves for:

(a) Known claims and expenses related to such claims;

(b) Claims incurred but not reported and any expenses associated such claims; and

(c) Unearned premiums, contributions, and assessments.

(3) The annual financial statement shall also include an actuarial opinion by a qualified actuary and a supporting reserve study regarding reserves for known claims and expenses associated with such claims. The

reserve study shall include documentation sufficient for another actuary practicing in the same field to evaluate the work. The documentation shall describe clearly the sources of data, material assumptions, and methods.

(4) The following statements shall be included with the annual financial statement:

(a) Balance sheet;

(b) Statement of gain or loss from operations;

(c) Statement of changes in financial position; and

(d) Notes to financial statements required by generally accepted accounting principles, which shall include a narrative explanation of all material transactions and balances of the self-insured group.

(5) No person shall make a deceptive statement or fail to correct a misstatement in connection with the solicitation of membership of a self-insured group.

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No. 10-693

Supreme Court, U.S.
FILED
FEB 1 - 2011
OFFICE OF THE CLERK

In the
Supreme Court of the United States

ERNST & YOUNG LLP, et al.,

Petitioners,

v.

SHARON P. CLARK,
Commissioner for the Kentucky Department of Insurance and Rehabilitator of AIK Comp, et al.,

Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Kentucky

REPLY BRIEF FOR PETITIONERS

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February 1, 2011

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REPLY BRIEF FOR PETITIONERS

This Court should grant certiorari here because (1) the Kentucky Supreme Court's expansive interpretation of the McCarran-Ferguson Act conflicts with *Department of Treasury v. Fabe*, 508 U.S. 491 (1993), and *AmSouth Bank v. Dale*, 386 F.3d 763 (6th Cir. 2004); (2) the question presented is important to anyone who deals with insurance companies and would like to insist on the federal right to arbitrate, including auditors, for whom access to arbitration is critical; and (3) this is an ideal vehicle because the McCarran-Ferguson Act is the sole reason Petitioners ("Ernst & Young") were unable to compel arbitration. By compelling arbitration of the parallel members' class action that did not implicate McCarran-Ferguson, the Kentucky Supreme Court made clear that, but for reverse preemption, arbitration would be required here as well.

The Brief in Opposition confirms many of these points. Respondent does not dispute that the question presented is an "important public matte[r]." Opp. 7. Indeed, she inadvertently underscores the importance of obtaining a hearing in a neutral tribunal. Respondent emphasizes that a state jury trial presents a risk of a runaway verdict that "arbitration cannot match" and that a state-court trial would expose Ernst & Young to public shame. Opp. 25–27. Respondent also admits that "the McCarran-Ferguson reverse-preemption issue" was dispositive and that no adequate or independent state ground bars review. Opp. 33.

Respondent's opposition to certiorari thus hangs on convincing this Court (1) that the conflicts with *AmSouth* and *Fabe* are not square; or (2) that this is a poor vehicle. Respondent is wrong on both fronts.

I. THE DECISION BELOW CONFLICTS WITH *AMSOUTH* AND *FABE*

A. There Is Nothing Special About Audits or "Self-Insurance Groups"

Respondent repeatedly denies that this is a "garden-variety" tort suit and argues instead that choice of forum here is unusually linked to the "business of insurance" because (1) AIK Comp ("AIK") was a "self-insurance group"; and (2) this case involves audits that were required by Kentucky's Insurance Code. *E.g.*, Opp. 9, 11–13, 19, 30, 32. But "the focus" of the McCarran-Ferguson Act is the relationship between policyholders and insurers, *Fabe*, 508 U.S. at 501, and the fact that this suit involves audits of a "self-insurance group" has no bearing on that relationship. This suit is as garden-variety as they come.

1. It is irrelevant that AIK is a self-insurance group. Even Respondent would concede that a self-insurance group's dispute over "office supplies" would qualify as "garden-variety," Opp. 19, implicating the split between *AmSouth* and *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277 (10th Cir. 1998). Audit services are no different. If anything, the fact that AIK is a self-insurance group makes the choice of forum *less*, not more, relevant, to policyholders. Unlike policyholders of an ordinary insolvent insurance company, AIK's members do not face the

prospect of losing coverage, but simply must make up for paying artificially low premiums in the past.

The root of AIK's insolvency was that it charged premiums that were too low. Opp. 44b–45b. As a self-insurance group with all members jointly and severally liable for any liabilities, AIK's members were charged assessments to make up the shortfall (and could be further assessed in the future). Pet. App. 6–7. As a result, claims will be paid and AIK's policyholders will have paid the proper amount for coverage; policyholders simply will have paid some premiums later rather than sooner.

To be sure, if a state-law forum proves outcome-determinative, the result will improve AIK's bottom line and indirectly benefit members. But if anything, that is more true of policyholders of an ordinary insurer who might regain coverage they otherwise would have lost. In any event, *Fabe* holds that such generalized effects on an insurer's bottom line are insufficient to trigger reverse preemption. 508 U.S. at 508–09. AIK's form cannot change that fundamental rule, otherwise every activity of a self-insurance group — even purchasing office supplies — would constitute the "business of insurance."

2. It is also immaterial that Kentucky law required AIK to obtain and file an audit with a state official. Ky. Rev. Stat. Ann. § 342.347(1) (2001).[1] While policyholders might care *whether* their

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[1] Respondent misleadingly implies that this section "created duties or liabilities" upon auditors. Opp. 11. It imposed a filing requirement on insurers, not auditors. § 342.347(1).

insurer's accounting statements are audited, they surely do not care *why* the insurer obtained the audit. *See Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 132 (1982).

And contrary to Respondent's assertions, Opp. 5, 30, state-court control over auditing disputes is not "integral" to Kentucky's regulatory scheme, much less the policyholder-insurer relationship. If it were, Kentucky and other states would insist on a state-court forum for all insurer-auditor disputes (without regard to delinquency), just as they ban arbitration of all insurer-policyholder disputes over coverage (without regard to delinquency). Ky. Rev. Stat. Ann. § 417.050(2); *e.g.*, Mo. Rev. Stat. § 435.350; Kan. Stat. Ann. § 5-401(c). But Kentucky has done no such thing and, to Petitioners' knowledge, no other state has either. Kentucky insists on a state-law forum for *any* third-party dispute — and only when there is a delinquency. Ky. Rev. Stat. Ann. § 304.33-040(3)(a). The statute reflects no special solicitude for the auditor-insurer relationship. It reflects a generic interest in establishing procedures for resolving the delinquency of an insurance company. Under *Fabe*, such a generic interest is insufficient. 508 U.S. at 508–09.

The allegation that Ernst & Young "contributed" to AIK's demise also does not trigger reverse preemption. Opp. 27. A "contribution" rule would render the McCarran-Ferguson Act virtually limitless, as any business decision that resulted in losses will have "contributed" to insolvent insurer's demise. This Court has repeatedly rejected such an expansive vision of reverse preemption. *See Fabe*,

508 U.S. at 508. The statute "exempts the 'business of insurance' and not the 'business of insurance companies.'" *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 217 (1979).

B. The Conflict with *AmSouth* Is Square

Respondent does not deny that there is a split between *AmSouth* and *Davister*. Respondent contends, however, that *AmSouth* is distinguishable from this case because it involved (1) the diversity jurisdiction statute, not the Federal Arbitration Act ("FAA"), 9 U.S.C. § 2; (2) an exclusive-jurisdiction state-court injunction, not an exclusive-jurisdiction state statute; and (3) a declaratory judgment action, not a suit for damages. Opp. 8–9.[2] But *AmSouth* itself confirms that these factors are immaterial. *See* Pet. 27–28.

1. In *AmSouth*, the Sixth Circuit found cases to be on point irrespective of these minor differences. First, the court found irrelevant whether the third-party sought refuge in a federal court or an arbitral tribunal; it treated as fungible the forum in *AmSouth*, a diversity suit, and *Davister*, *Munich Am. Reins. Co. v. Crawford*, 141 F.3d 585 (5th Cir. 1998), and *Stephens v. Am. Int'l Ins. Co.*, 66 F.3d 41 (2d Cir. 1995), which are FAA suits. *AmSouth*, 386 F.3d at 781–72. Second, the court found irrelevant whether exclusive state-court jurisdiction was

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[2] Respondent also notes that this case involves state-required audits for a "self-insurance group," while *AmSouth* involved banking services for a traditional insurer. Opp. 9. As *supra* Part I.A shows, these are distinctions without a difference.

required by an injunction or a statute; it viewed the injunctions in *AmSouth* and *Munich* as fungible with the statutes in *Davister* and *Stephens*. *Id.* Third, it found irrelevant whether the insurer initiated suit offensively or the putative tortfeasor did defensively; it treated the declaratory-judgment posture of *AmSouth* as parallel to *Gross v. Weingarten*, 217 F.3d 208 (4th Cir. 2000), and other insurer suits for damages. *AmSouth*, 386 F.3d. at 782–73.

AmSouth ultimately held that barring a neutral forum from adjudicating an "ordinary suit" between an insolvent insurer and a third-party tortfeasor "implicates a 'regulation of the business of insurance' only in the attenuated fashion rejected in *Fabe*." *Id.* at 783. That rule is correct and, as the Sixth Circuit' recognized, does not depend on whether (1) the neutral forum is a federal court or an arbitral tribunal; (2) the exclusive-jurisdiction rule appears in a statute or an injunction; or (3) the suit is for damages or a declaratory judgment. If the Kentucky Supreme Court had applied the Sixth Circuit's rule, it would have reversed, not affirmed. That is the definition of a conflict under Rule 10.

2. *AmSouth* was correct to reject these distinctions. First, with respect to reverse preemption of a state exclusive-jurisdiction provision, the FAA and the diversity-jurisdiction statute are analytically identical. Neither law "specifically relates" to insurance. 15 U.S.C. § 1012(b). And both guarantee access to a non-state-court forum. Therefore, both preempt state exclusive-jurisdiction provisions in the exact same way. Second, there is no functional difference between an injunction

prohibiting access to any other forum and a statute imposing exactly the same prohibition — especially where the injunction flows from a state statute.[3] Third, it would be nonsensical to allow Ernst & Young to arbitrate a declaratory action evaluating whether it has valid defenses to Respondent's claims, but not to arbitrate whether those same defenses are valid against the same claims when brought in an action for damages. The two postures are flip sides of the same coin and implicate policyholders' interests only in the same "attenuated fashion." *AmSouth*, 386 F.3d at 783.

3. While *Munich* and *Stephens* reflect the general disarray in the lower courts, they do not support Respondent. As the Petition explained, those cases involve a different question. Pet. 30–32. *AmSouth*, *Davister*, and this case involve ordinary tort suits against a third party outside the insurance industry. *Munich* and *Stephens* involve coverage disputes between an insurer and a reinsurer. *Munich*, 141 F.3d at 587–88; *Stephens*, 66 F.3d at 42. Coverage disputes directly impact policyholding insurers and reinsurance is "'limited to entities within the insurance industry.'" Pet. 30–31 (quoting

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[3] Respondent misleadingly suggests that the antisuit injunctions in *AmSouth* were not entered pursuant to a state liquidation law. Opp. 10. The injunctions in *AmSouth* were entered pursuant to Miss. Code Ann. § 83-24-47(1), Mo. Rev. Stat. § 375.1188(1), and Okla. Stat. tit. 36, § 1904(B), which are modeled on the Uniform Insurers Liquidation Act. Brief of Appellants at 8, *AmSouth*, 2003 WL 24309280.

Pireno, 458 U.S. at 129). "The nexus to the 'business of insurance' is thus substantially tighter." *Id.*[4]

Respondent is also doubly wrong to argue that barring arbitration here spreads risks by "introducing the possibility of jury verdicts into the process for resolving disputed claims." Opp. 26 (quoting *Standard Sec. Life Ins. Co. v. West*, 267 F.3d 821, 824 (8th Cir. 2001) (per curiam)). First, unlike *West*, this suit does not remotely involve "the process for resolving disputed *claims*," *i.e.*, claims for insurance coverage. *West*, 267 F.3d at 822; *see* Pet. 22, 30–31. It involves a tort suit by an insurer against a third party. Second, and more fundamentally, insurance is about spreading pre-existing risks — not creating new risks for anyone who does business with an insurance company.

Respondent also seeks false comfort in this Court's denials of certiorari in *Davister* and *Munich*. Opp. 6–7. *Munich* is distinguishable, and both cases were decided before *AmSouth*, and thus there was no split at the time. No petition for certiorari was filed in *AmSouth*. Thus, this Court's prior treatment of this issue was consistent with Rule 10's criteria. Those same criteria support certiorari here to review an important federal question on which the lower courts are now split.

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[4] *Stephens* highlights an unfairness of Kentucky's exclusive-jurisdiction provision: It prevents third-party defendants from litigating anywhere but Kentucky state court — but allows the rehabilitator to sue even in the Second Circuit.

C. The Conflict with *Fabe* is Square

1. Respondent denies that the Kentucky Supreme Court assessed the purpose of Kentucky's arbitration ban by looking to the purpose of the IRLL "as a whole," rather than applying the subsection-by-subsection approach *Fabe* commands. Opp. 19–21. But Respondent relies entirely on quotations taken out of context.

The Kentucky Supreme Court's analysis of the purpose prong is so simplistic that it fits in a single paragraph. Pet. App. 10–11. Respondent ignores this paragraph and instead relies upon passages discussing McCarran-Ferguson Act's third prong: whether the FAA conflicts with the exclusive-jurisdiction provision. *Compare* Opp. 19–21 (citing Pet. App. 17–19), *with* Pet. App. 17–19. But under *Fabe*, any conflict at all is not enough; the provision at issue must also be aimed at "regulating the business of insurance." In only reviewing the purpose of the IRLL as a whole, the Kentucky Supreme Court never meaningfully addressed this question — and fundamentally missed *Fabe*'s point.

2. The Kentucky Supreme Court's decision also conflicts with *Fabe* in holding that the McCarran-Ferguson Act extends to this proceeding. Respondent seeks to distinguish *Fabe*'s bottom line, but she essentially rehashes her earlier arguments: that (1) *Fabe* is not an FAA case, it is only about claim priority; and (2) the impact on policyholders is not attenuated because AIK is a "self-insurance group" and the suit involves audits. Opp. 14, 22–23. Not even the Kentucky Supreme Court believed that *Fabe*

was limited to the claims-priority context. Pet. App. 11. And the self-insurance and audit-requirements distinctions are red herrings. *Supra* Part I.A.

The conflict with *Fabe* is therefore square. *Fabe* held that generalized rules manipulating the claim priority process to benefit an insolvent insurer are unprotected because the impact on the policyholder-insurer relationship is too attenuated to constitute regulation of the "business of insurance." 508 U.S. at 508–09. The same is true for Kentucky's generalized and "extremely broad" rule granting exclusive jurisdiction over "all matters in any way relating to any delinquency" — including garden-variety tort claims. Pet. App. 14. Such a rule might benefit an insurer's bottom line (at the expense of every policy embraced by the FAA), but such an indirect impact on policyholders is too attenuated to trigger reverse preemption.

II. THIS IS AN IDEAL VEHICLE

1. Respondent half-heartedly argues that this vehicle is subpar because, on remand, the Kentucky Supreme Court could affirm on alternative state-law grounds. Opp. 32–36. But Respondent admits that "the McCarran-Ferguson reverse-preemption issue" was outcome-determinative and that no adequate or independent state ground bars review. Opp. 33. There is therefore no vehicle problem.[5]

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[5] Respondent also suggests that Ernst & Young's *Fabe* argument is not preserved. Opp. 14. But Ernst & Young presented *Fabe* to the Kentucky Supreme Court, Respondent

Respondent's alternative state-law argument is also meritless. Respondent asserts that AIK's arbitration clause is unenforceable against her because, as Rehabilitator, she did not sign it. Opp. 34. But Respondent can only sue Petitioners by stepping into AIK's shoes: Respondent's suit is "on behalf of [AIK]" and raises "causes of action that [AIK] could have maintained in its own name." Opp. 42b–43b. Respondent cannot step into AIK's shoes to bring a claim and then pretend to be a stranger to AIK's arbitration clause. Indeed, the Kentucky Supreme Court rejected a virtually identical argument below. It held that AIK's arbitration clause bound the class members' derivative claims — even though they did not sign it either. Pet. App. 23.

2. The Kentucky Supreme Court's decision to compel arbitration of the members' class action makes this vehicle even cleaner. The arbitration clause is indisputably valid — the Kentucky Supreme Court enforced it. And the only reason it declined to compel arbitration of Respondent's claims was because it held that the McCarran-Ferguson Act shielded them. Pet. App. 22. But for the Kentucky Supreme Court's interpretation of the McCarran-Ferguson Act, the FAA would command arbitration here as well.

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engaged on the issue, and that court did not apply a procedural bar; it rejected Ernst & Young's argument on the merits. *See* Pet. 10–13. That is more than enough to preserve the issue. *Cone v. Bell*, 129 S. Ct. 1769, 1782 (2009) (this Court will not "apply state procedural bars where state courts have themselves declined to do so").

3. The need for review here is also particularly pressing because Respondent and the state courts embrace the "hostility to arbitration that Congress intended the FAA to override." Pet. 34. Indeed, Respondent amplifies the rhetoric by emphasizing that arbitration must be prohibited to expose Ernst & Young to a heightened risk of a runaway jury verdict — and to public shame in the process. Opp. 25–27.

Congress and this Court have rejected this anti-arbitration prejudice by creating and vigorously enforcing the FAA's guarantee of access to arbitration. As *amicus* Center for Audit Quality illustrates, arbitration is "often far superior" for resolving auditing disputes, as appropriate damages are generally awarded when — but only when — a deficient audit causes injury. CAQ Br. 10. Ernst & Young accordingly insisted on arbitration and AIK agreed. The Kentucky Supreme Court correctly recognized that the FAA requires arbitration of the members' claims. But it rendered that a hollow victory (and thwarted the FAA's goals) by allowing the Rehabilitator's strikingly similar suit — seeking similar damages based on the same derivative negligence claims relating to the same audits — to avoid arbitration.

It is critical to auditors and others who choose arbitration when doing business with insurance companies that their choice be honored. Otherwise, as here, they face being dragged before hostile courts in an avowed effort by a state official to take advantage of the state jury system. Ernst & Young would not have audited AIK absent its federally-

protected agreement to arbitrate disputes in a neutral forum.

The Kentucky Supreme Court's decision exposes Ernst & Young to precisely the risk that the FAA protects against. That court held that the FAA was trumped by Kentucky's "extremely broad" exclusive-jurisdiction provision — a provision that applies only in liquidation. The court below did all this even though choice of forum over Respondent's suit impacts policyholders, if at all, only in the extraordinary attenuated manner *Fabe* rejected. That holding conflicts with this Court's precedents and *AmSouth* and warrants certiorari.

CONCLUSION

For the foregoing reasons, this Court should grant the petition for certiorari.

RESPECTFULLY SUBMITTED

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ERNST & YOUNG LLP, et al.,

Petitioners,

v.

SHARON P. CLARK,

Commissioner for the Kentucky Department Of Insurance and Rehabilitator of AIK Comp, et al.,

Respondents.

On Petition For A Writ of Certiorari to the Supreme Court of Kentucky

BRIEF OF THE CENTER FOR AUDIT QUALITY AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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BRIEF OF THE CENTER FOR AUDIT QUALITY AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

INTEREST OF THE *AMICUS CURIAE*[1]

The Center for Audit Quality ("CAQ") is a public policy organization that seeks to aid investors and the capital markets by advancing constructive suggestions rooted in the audit and accounting profession's core values of integrity, objectivity, honesty, and trust. Any U.S. accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") may join the CAQ. The CAQ is affiliated with the American Institute of Certified Public Accountants, and has approximately 750 U.S. public company accounting firms as members, representing tens of thousands of professionals dedicated to audit quality.

The CAQ seeks to improve the reliability of public company audits and to enhance their relevance for investors, particularly in this time of growing financial complexity and globalization. The CAQ is dedicated to helping increase public confidence in the auditing process and to maintaining high standards in the accounting profession. To fulfill its mission, the

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[1] No counsel for a party wrote this brief in whole or in part, and no counsel for a party or party made a monetary contribution intended to fund the preparation or submission of this brief. No person or entity other than *amicus curiae*, its members, or its counsel made a monetary contribution to this brief's preparation or submission. Petitioners and respondents have consented to the filing of this brief; their written consents have been submitted to the Clerk.

CAQ offers recommendations to policymakers, issues technical support for public company auditing professionals, and participates in the public discussion about financial reporting. For example, among many other recent activities, the CAQ has filed *amicus* briefs in cases concerning the unconstitutionality of statutory provisions for removal of members of the PCAOB; the confidentiality of documents, communications, and information regarding or relating to a PCAOB inspection; and the distinction between primary and secondary liability under Section 10(b) of the Securities Exchange Act of 1934.

The CAQ has a keen interest in legal rules that affect auditors and the audit process, and the broader impact of such rules on investors and capital markets. Enforcement of agreements between auditors and their clients to resolve their disputes through arbitration, rather than litigation, is a matter of surpassing importance to the audit profession and clients. In the Federal Arbitration Act, Congress instructed courts to treat arbitration agreements as "valid" and "enforceable" absent traditional legal or equitable grounds for the judicial revocation of a particular arbitration agreement. 9 U.S.C. § 2. Acting in reliance on that protection, auditors and their clients routinely agree that disputes arising from an audit engagement will be arbitrated rather than litigated. These agreements, freely negotiated between sophisticated commercial enterprises, serve important interests. In this context, as in many others, arbitration is often preferred because it will avoid the cost and delay associated with litigation, and because the parties value the experience and expertise that arbitrators bring to the dispute resolution process. By agreeing to arbitrate, the parties can assure that

their disputes will be resolved by arbitrators who understand complex business transactions, the client's industry, and the accounting and auditing principles that are often implicated in these disputes. Both auditors and their clients realize substantial benefits from arbitration.

In this case, the Supreme Court of Kentucky refused to enforce an arbitration agreement between an audit firm (petitioner Ernst & Young LLP) and its client (AIK Comp). That refusal was not based on any "grounds as exist at law or in equity for the revocation" of the agreement, which, if such grounds existed, would have been consistent with the FAA. See 9 U.S.C. § 2. Rather, the refusal was based on the mistaken conclusion that the FAA was not applicable at all, because it was "reverse preempted" by state law. That conclusion, in turn, rested on a misreading of another federal statute, the McCarran-Ferguson Act, which provides that federal law, unless it "specifically relates to the business of insurance," may not be construed to "invalidate, impair, or supersede" state laws enacted "for the purpose of regulating the business of insurance." 15 U.S.C. § 1012(b).

In reaching this incorrect result, the Supreme Court of Kentucky disregarded this Court's decision in *Dep't of Treasury* v. *Fabe*, 508 U.S. 491 (1993). As the petition explains (Pet. 16-18), *Fabe* requires an inquiry whether the *specific* state statutory provision that supposedly would be "impair[ed]" by the federal statute was enacted to regulate "the business of insurance." "Reverse preemption" under the McCarran-Ferguson Act is not justified merely because that specific state statutory provision is, in the words of the opinion below, "a part" of a broader statutory

scheme that regulates the business of insurance. Pet. App. 11. Even worse, the Supreme Court of Kentucky failed to honor the distinction that this Court consistently has drawn between "the business of insurance" (which the McCarran-Ferguson Act addresses) and "the business of insurance companies" (which it does not address), and prevented an arbitration that would not "invalidate, impair, or supersede" – indeed, would not alter in any meaningful way – the "substantive rights" of either party to the dispute. See Pet. 23-25. The decision expands the application of reverse preemption well beyond the limits established by this Court, and deepens an existing circuit split between *AmSouth Bank* v. *Dale*, 386 F.3d 763 (6th Cir. 2004), and *Davister Corp.* v. *United Republic Life Ins. Co.*, 152 F.3d 1277 (10th Cir. 1998). See Pet. 26-33.

The CAQ respectfully submits this *amicus curiae* brief to underscore that the holding below has ramifications far beyond the particular dispute involved in this case. If the McCarran-Ferguson Act is improperly construed, as in the decision below, it could abrogate existing arbitration agreements and adversely affect the terms of future agreements between auditors and insurance company clients. The CAQ urges this Court to grant the petition and to correct the erroneous decision below.

SUMMARY OF ARGUMENT

I. By reviewing, auditing, and opining on the financial statements of America's businesses, audit firms provide an essential national service. For that reason, one of the CAQ's top priorities is to foster legal regimes that appropriately resolve claims against auditors in a timely and efficient manner. There are

formidable obstacles to achieving that goal. Audit-related disputes typically involve complex factual and legal issues: whether there were material misstatements or omissions in the company's financial statements; if so, whether the auditor should have detected those problems; and if so, whether and to what degree did that failure cause the plaintiff compensable injury. Litigating such complex issues can be extraordinarily costly, and arbitration can substantially reduce those costs. By agreeing to arbitrate their disputes, parties can also ensure that their disputes will be resolved by decisionmakers whose expertise and experience will enhance the dispute resolution process. Because of their expertise, skilled arbitrators are well positioned to identify outcome-determinative issues and to efficiently structure discovery and the hearing process to focus on those issues. Arbitrators are also less likely than lay jurors to misunderstand the role of auditors and the meaning of their opinions, and less likely to render disproportionate judgments. And arbitration may be especially attractive if a party has reasonable concerns of parochialism by state courts and local jurors. Arbitration is not a perfect solution, and some parties may prefer to litigate their disputes, rather than arbitrate. Existing law protects their rights to choose to do so when they enter into contracts. But the FAA also protects the rights of parties to choose to arbitrate their disputes, and requires courts to enforce agreements to do so. The decision below would change settled law and sharply limit the arbitration alternative.

II. As misconstrued by the Supreme Court of Kentucky, the McCarran-Ferguson Act could deprive any party that provides goods or services to an insur-

ance company of its contractual right to arbitrate. For auditors and their clients, those arbitration rights are especially important. Auditors face a large number of claims that allege very large amounts of damages, and incur very large costs litigating such claims. The potential cost savings from arbitrating rather than litigating are therefore very large. Given the number and magnitude of claims, auditors and their clients also have compelling reasons to reduce the risk that the resolution of any claim may be swayed by factors other than the merits of the claim – in particular, to reduce the risk that common public misconceptions about auditing may improperly influence a jury's verdict. If auditors are unable to enforce arbitration agreements with insurance companies, the enhanced cost and risk of litigating rather than arbitrating disputes will predictably be passed on to insurance company clients, with a corresponding rise in premium costs.

Misinterpretation of the McCarran-Ferguson Act could strip away arbitration rights in a very large sector of the economy. Insurance is a $1.7 trillion industry, served by nearly 8000 insurers, and a refusal to enforce arbitration agreements with insurance companies in rehabilitation would deny arbitration rights in the exact circumstance in which those rights are most valuable – when claims are brought before state court judges and juries by state insurance officials or receivers seeking to maximize recoveries in the wake of the failure of a local insurance company, and auditors face the greatest risk of being treated as a deep pocket reinsurer. The decision below therefore threatens real and serious harm to the auditing profession and the businesses, investors, and markets

that depend on that profession. The petition should be granted.

ARGUMENT

Section 2 of the Federal Arbitration Act provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. "[T]he basic purpose of the Federal Arbitration Act is to overcome courts' refusals to enforce agreements to arbitrate." *Allied-Bruce Terminix Companies* v. *Dobson*, 513 U.S. 265, 270 (1995) (citing *Volt Information Sciences, Inc.* v. *Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 474 (1989)). The FAA "preempts state law; and * * * state courts cannot apply state statutes that invalidate arbitration agreements." *Dobson*, 513 U.S. at 272 (citing *Southland Corp.* v. *Keating*, 465 U.S. 1, 15-16 (1984)). In this case, the Supreme Court of Kentucky did what *Dobson* and *Southland* said state courts cannot do. It held that a Kentucky statute's "broad grant of exclusive jurisdiction to the Franklin Circuit Court in matters relating to the delinquency of insurance companies preempts and supersedes the Federal Arbitration Act and its policy favoring arbitration." Pet. App. 9-10.

That holding arose from a misinterpretation of the McCarran-Ferguson Act, which provides that federal law, unless it "specifically relates to the business of insurance," may not be construed to "invalidate, impair, or supersede" state laws enacted "for the purpose of regulating the business of insurance." 15 U.S.C. § 1012(b). This Court, however, has emphasized that the McCarran-Ferguson Act addresses "the 'business of insurance' and not the 'business of insur-

ance companies.'" *Group Life & Health Ins. Co.* v. *Royal Drug Co.*, 440 U.S. 205, 217 (1979). The "business of insurance" typically involves "transferring or spreading a policyholder's risk" to the insurer, the policy relationship between the insurer and the insured, and practices that are limited to the insurance industry. *Union Labor Life Ins. Co.* v. *Pireno*, 458 U.S. 119, 129 (1982); *Fabe*, 508 U.S. at 505. For that reason, an insurance company's "arrangements for the purchase of goods and services" – undoubtedly part of the business of an insurance *company* – are not the "business of insurance." *Royal Drug*, 440 U.S. at 214.

In this case, the plaintiff has asserted an ordinary tort claim arising from an insurance company's contract to purchase auditing and accounting services. That claim has nothing to do with transferring or spreading risk or the policy relationship between the insurer and the insured. The same is true for the question whether to resolve that claim through arbitration or litigation. The underlying claim of auditor negligence, and whether to arbitrate or litigate that claim, are not unique to the insurance industry; those issues may arise in any industry.

The decision below therefore does not meaningfully advance the state's interest in regulating the business of insurance. It does, however, threaten serious harm to the federal policy of protecting consenting parties' rights to secure the benefits of resolving commercial disputes through arbitration, rather than litigation. Countless businesses have entered into contracts in reliance on the right to arbitrate, rather than litigate, disputes arising under the contract. As we explain below, contracts between auditors and

their clients routinely include arbitration provisions, and do so because arbitration provides compelling benefits to both parties. A decision that jettisons those arbitration rights threatens to upset those settled expectations, and to cause serious harm to the broader public interest in promoting effective auditing services.

I. CONTRACTING PARTIES AGREE TO ARBITRATE IN ORDER TO OBTAIN TIMELY AND EFFICIENT RESOLUTION OF THEIR DISPUTES BY EXPERT ADJUDICATORS

Auditors provide services that are essential to businesses, their investors and creditors, and the national economy. "Ultimately, it is a combination of transparency and trust that enables our financial markets to function efficiently. A strong and vibrant auditing profession is a critical element of that regime and especially important to the U.S. capital markets where more than 100 million people invest their savings and retirement assets." Department Of The Treasury, Advisory Committee On The Auditing Profession, FINAL REPORT II:1 (Oct. 6, 2008) (hereafter cited as "*Advisory Committee Report*"); see also Commission On The Regulation Of U.S. Capital Markets In The 21st Century, REPORT AND RECOMMENDATIONS 8 (Mar. 2007) (hereafter cited as "*Commission Report & Recommendations*") ("The independent auditing firms play a critical role in our capital markets by providing reasonable assurance on the financial statements of public companies. Thus, the Commission believes that sustaining a strong, economically viable public company audit profession is vital to domestic and global capital markets.").

Because of the importance of audit services, one of the principal objectives of the CAQ is to promote a legal regime that effectively and fairly resolves legal claims against auditors. Such a regime should resolve allegations of inadequate performance by auditors in a timely, efficient, and predictable manner. It should minimize both false negatives (erroneous decisions that permit auditors to escape liability when their performance has been deficient under applicable professional standards and has caused compensable injury) and false positives (erroneous decisions that hold auditors liable when they have done nothing wrong or, if the auditor is liable, that award damages that are excessive under the applicable legal standards). As we explain below, arbitration is often far superior to litigation in state and federal courts in achieving those objectives.

Achieving these objectives is no easy task. Claims of inadequate auditor performance require a judgment whether a business's financial statements were materially misleading. That judgment often requires a complex factual inquiry (to understand the underlying business transactions, their economic rationale, and their anticipated and actual financial results) *and* a sophisticated understanding and application of the relevant accounting and auditing principles (which require the exercise of professional judgment). But even if there is a determination that a business's financial statements were materially misleading, that determination is merely the *beginning* of the inquiry. There remains the question whether the auditor failed to comply with the relevant professional standards when opining on those financial statements. This determination, too, will likely involve complex factual issues and difficult questions about the proper

exercise of professional judgment. Finally, even if the auditor's opinion was actionable, assessing loss causation and measuring damages add more difficulty, because it is often unclear whether, or to what extent, a plaintiff's financial losses are attributable to materially misleading financial statements and an auditor's opinion thereon, rather than the business's performance or other factors.

Auditors and their clients, alike, recognize that in resolving such questions, arbitration has many advantages. For that reason, agreements between auditors and their clients often provide that disputes will be subject to arbitration, rather than litigation.

Arbitration can generally resolve disputes more efficiently and at lower cost than can litigation. Even routine litigation is often slow moving and, with protracted discovery, can be hugely expensive. But claims against auditors are by no means routine litigation. Such claims, when litigated, entail complex legal and factual issues, enormous discovery costs, and the intensive involvement of experts.

Arbitration can substantially reduce these costs by limiting discovery and streamlining procedures. For example, while federal discovery rules are famously "liberal," *Swierkiewicz* v. *Sorema N. A.*, 534 U.S. 506, 512 (2002), the American Arbitration Association's rules governing arbitration in accounting disputes permit the arbitrator, "[c]onsistent with the expedited nature of arbitration," to set the parameters of discovery, including whether to permit discovery at all. AAA, Professional Accounting and Related Services Dispute Resolution Rules, Rule 10, (http://www.adr.org/sp.asp?id=22012).

This Court has consistently recognized the superior efficiency and lower expense that arbitration typically offers over litigation. Just last Term the Court acknowledged that "[i]n bilateral arbitration, parties forgo the procedural rigor and appellate review of the courts in order to realize the benefits of private dispute resolution: lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes." *Stolt-Nielsen S.A.* v. *Animalfeeds Int'l Corp.*, 130 S. Ct. 1758, 1775 (2010). Thus, a "prime objective of an agreement to arbitrate is to achieve 'streamlined proceedings and expeditious results.'" *Preston* v. *Ferrer*, 552 U.S. 346, 357-58 (2008) (quoting *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 633 (1985)); see also *Gilmer* v. *Interstate/Johnson Lane Corp.*, 500 U.S. 20, 31 (1991) (same).

By agreeing to arbitrate their disputes, auditors and their clients can also ensure that such disputes will be heard by decisionmakers with expertise and experience that will enhance the quality of the dispute resolution process. As many courts – this Court first among them – have recognized, access to expert adjudicators provides a compelling reason to choose arbitration:

> "[A]daptability and access to expertise are hallmarks of arbitration. The anticipated subject matter of the dispute may be taken into account when the arbitrators are appointed, and arbitral rules typically provide for the participation of experts either employed by the parties or appointed by the tribunal.

Mitsubishi Motors, 473 U.S. at 633; see also, *e.g.*, *Alexander* v. *Gardner-Denver Co.*, 415 U.S. 36, 57 (1974) ("Parties usually choose an arbitrator because they trust his knowledge and judgment concerning the demands and norms of industrial relations."); *Stolt-Nielsen*, 130 S. Ct. at 1775 ("benefits of private dispute resolution" include "the ability to choose expert adjudicators to resolve specialized disputes); *Uhl* v. *Komatsu Forklift Co.*, 512 F.3d 294, 308 (6th Cir. 2008) ("Arbitrators are often chosen for their expertise and community involvement * * * *"); *Positive Software Solutions, Inc.* v. *New Century Mortg. Corp.*, 476 F.3d 278, 285-86 (5th Cir. 2007) (en banc) ("expertise" and the "benefit of specialized knowledge" are among arbitration's "most attractive features apart from speed and finality"); *Lucent Techs., Inc.* v. *Tatung Co.*, 379 F.3d 24, 28 (2d Cir. 2004) ("[A] principal attraction of arbitration is the expertise of those who decide the controversy * * * *") (quotation marks omitted); *Lefkovitz* v. *Wagner*, 395 F.3d 773, 780 (7th Cir. 2005) (Posner, J.) (same); *ANR Coal Co.* v. *Cogentrix of N.C., Inc.*, 173 F.3d 493, 500 (4th Cir. 1999) (same); *Rosenberg* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 170 F.3d 1, 7 n.4 (1st Cir. 1999) (same); *Bowles Fin. Group, Inc.* v. *Stifel, Nicolaus & Co.*, 22 F.3d 1010, 1013 (10th Cir. 1994) (same); *Marino* v. *Writers Guild of Am., East, Inc.*, 992 F.2d 1480, 1483 (9th Cir. 1993) (same); see also, *e.g.*, AAA, Professional Accounting and Related Services Dispute Resolution Rules, Rule 4, (http://www.adr.org/sp.asp?id=22012) (establishing a "National Panel of Accounting and Related Services Arbitrators" based on eligibility requirements set in consultation with the National Accounting Industry Dispute Resolution Committee).

The expertise that arbitrators bring to the dispute resolution process is valuable for many reasons. That expertise is an important factor in achieving timely and efficient disposition of claims. Arbitrators may have greater knowledge of the governing legal principles at the *outset* of the dispute resolution process than non-expert adjudicators would have at the *conclusion* of the process. For that reason, skilled arbitrators may be better positioned than judges to identify the issues that will be outcome determinative and to efficiently structure discovery and the hearing process to focus on those issues.

The expertise of arbitrators also reduces the risk that the ultimate resolution of the dispute will be swayed by a misunderstanding of the role and responsibilities of auditors and the meaning of audit opinions. The general public – and, unfortunately, many lay jurors and some courts – often have fundamental misunderstandings about those matters. A common misconception is that in all cases there is a single, "right" way to present a company's financial performance and that the "right" presentation is a function of objective facts that can be readily confirmed. Starting with those false premises, many believe that a clean audit opinion is tantamount to the auditor's guarantee that the company's financial statements reflect the only permissible presentation of the company's financial performance and are completely accurate in every detail. If a company's financial statements are later found to be materially misleading, the thinking goes, the auditor must have been derelict for not discovering and reporting the truth. Such beliefs, though widely held, are simply wrong.

An auditor's opinion "is not a simple statement of verifiable fact that * * * can be easily checked against uniform standards of indisputable accuracy." *Bily* v. *Arthur Young & Co.*, 3 Cal. 4th 370, 400 (Cal. 1992). Rather, it is a "professional opinion" that is the "final product of a complex process involving discretion and judgment on the part of the auditor at every stage" because the opinion is "based on the auditor's interpretation and application of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions." *Ibid.*

What is more, the auditor must rely on information supplied by the client. "For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business" and auditors' decisions about which sample of records to examine, and whether and how to verify the accuracy of the records, are themselves decisions that "require a high degree of professional skill and judgment." *Id.* at 380. As the Third Circuit has explained, an audit "does not guarantee that a client's accounts and financial statements are correct any more than a sanguine medical diagnosis guarantees well-being; indeed, even an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect a material omission or misstatement." *In re IKON Office Solutions, Inc.*, 277 F.3d 658, 673 (3d Cir. 2002).

Because arbitrators are less likely to harbor such misconceptions, their expertise in the relevant subject matter naturally leads to better decision making. As this Court put it, "[A]lign[ing] (1) decisionmaker with (2) comparative expertise will help better to se-

cure a fair and expeditious resolution of the underlying controversy – a goal of arbitration systems and judicial systems alike." *Howsam* v. *Dean Witter Reynolds, Inc.*, 537 U.S. 79, 85 (2002); see also, *e.g.*, *Lefkovitz*, 395 F.3d at 780 ("Parties that opt for arbitration trade the formalities of the judicial process for the expertise and expedition associated with arbitration, a less formal process of dispute resolution by an umpire who is neither a generalist judge nor a juror but instead brings to the assignment knowledge of the commercial setting in which the dispute arose."); *ANR Coal Co.*, 173 F.3d at 500 ("Parties value commercial arbitration, at least in part, because they prefer a tribunal knowledgeable about the subject matter of their dispute to a generalist court with its austere impartiality but limited knowledge of subject matter." (internal quotation marks omitted)).

Arbitration has another important advantage in cases, such as this one, in which a party may have reasonable concerns of state parochialism. In this case, the claim involves an in-state insurer and was brought by a state official (the rehabilitator) demanding a trial by a state court jury with an elected judge. See Ky. Const. § 117. Such cases present the risk that the jury's or judge's natural sympathies may lie with the local "victim" rather than the distant and faceless audit firm. As this Court has already recognized (in the punitive damage context), juries may "use their verdicts to express biases against big businesses, particularly those without strong local presences." *State Farm Mut. Auto. Ins. Co.* v. *Campbell*, 538 U.S. 408, 417 (2003) (quotation marks omitted). Local juries may be acutely conscious of the impact of a business failure within their own community; state court judges may lack experience or training related

to the kinds of issues that may be determinative of claims against auditors; and, where a local business has failed, its auditor may be perceived as a deep-pocketed defendant that is the only solvent entity from which plaintiffs may seek to recover their losses. For these reasons, too, parties may reasonably believe that submission of audit disputes to expert arbitrators will reduce the risk that the dispute will be resolved on any basis other than its merits.

Reflecting the many advantages of arbitration, parties to commercial arbitration are generally very satisfied with its results and prefer it to litigation – which is reflected in the high incidence of agreements to arbitrate within commercial sectors, including the accounting and auditing industries. See generally David B. Lipsky & Ronald L. Seeber, THE APPROPRIATE RESOLUTION OF CORPORATE DISPUTES: A REPORT ON THE GROWING USE OF ADR BY U.S. CORPORATIONS (1998). To be sure, no legal regime can achieve perfection, and arbitration, like litigation, has both advantages and disadvantages. After weighing the alternatives, some parties may prefer to litigate their disputes, rather than submit them to arbitration. Existing law protects the rights of parties to choose that option (explicitly or by default) when they enter into contracts. But existing law also protects their rights to choose to resolve future disputes through arbitration. When both parties agree that arbitration should be used – because they value the expedition and efficiency of arbitration, the expertise of arbitrators, or for any other reason – the FAA requires courts to honor and enforce that choice. Unfortunately, the decision below, if uncorrected, would change settled law and sharply limit the arbitration alternative.

II. THE BENEFITS OF ARBITRATION ARE ESPECIALLY IMPORTANT TO AUDITORS AND THEIR CLIENTS

The decision below seriously undermines the federal interest in protecting consenting parties' right to arbitrate their disputes. Because of the widely-recognized advantages of arbitration, a large proportion of commercial agreements contain arbitration provisions. As misconstrued by the Supreme Court of Kentucky, the McCarran-Ferguson Act could deprive *any* party that provides goods or services to an insurance company of its contractual right to arbitrate and for that reason, the consequences of such a misinterpretation are far reaching.

For auditors, their clients, and their clients' investors and creditors, the limitation on arbitration rights is particularly significant. Because claims against auditors involve complex issues that can be extraordinarily costly to litigate, the time and cost savings of arbitration can be very large. A recent study indicated that the six largest auditing firms, on average, incurred litigation and practice protection costs that were greater than 15% of their audit-related revenues. *Advisory Committee Report* at VII.25. Parties to such disputes bear these costs directly, in addition to the numerous indirect expenses they incur through the distraction of litigation and resulting lost productivity.

The ability to ensure that claims are resolved by expert decisionmakers is also a substantial benefit for auditors and their clients. In 2006, the nation's largest association of businesses – an organization that represents the interests of audit *clients* – issued a report that described auditing as "a profession at risk,"

in large part because of "litigation risk" related to "misunderstandings about the meaning and nature of accrual accounting systems and the level of precision inherent in such systems." U.S. Chamber of Commerce, AUDITING: A PROFESSION AT RISK 5 (Jan. 2006) (http://www.uschamber.com/sites/default/files/reports/0601auditing.pdf). The report emphasized the importance of arbitration and other forms of alternative dispute resolution for claims against auditors, cautioning that "[i]t is simply not reasonable to expect juries and nonexpert judges to properly evaluate arcane accounting judgments and auditing methodologies." *Id.* at 11; see also *Commission Report & Recommendations* at 109 ("[M]uch of the confidence of the entire market now rests on just four [audit firms], and * * * litigation risk is a substantial impediment toward expanding the number of audit firms willing to audit large public companies.").

Moreover, given the magnitude of many of the claims at issue, auditors and clients have compelling reasons to seek to reduce the risk that a dispute will be resolved on any basis other than its merits. Auditors are reasonably concerned that complaints against them, even if they lack merit, may receive a sympathetic hearing from those who harbor misconceptions about the role of auditors and the meaning of their opinions. Many of the plaintiffs asserting such claims have suffered very large losses, perhaps (but not necessarily) through no fault of their own. By the time those losses have occurred, the company that actually issued the materially misleading financial statements may be insolvent, and the audit firm is often the only defendant from which the plaintiff can hope to recover its losses. The risk of a catastrophic liability finding by an unsophisticated judge or jury

that wants to compensate innocent victims for their losses is very real, and cannot be entirely mitigated by the hope that such errors eventually will be corrected. See, *e.g.*, *BDO Seidman, LLP* v. *Banco Espirito Santo Int'l*, 38 So. 3d 874, 882 (Fla. Dist. Ct. App. 2010) (reversing $500 million judgment against BDO Seidman, LLP and observing that erroneous judgment "would plainly lead to [the defendant's] financial demise" (internal quotation marks omitted)).

The decision below threatens real and serious harm to the auditing profession *and* to auditors' clients. Indeed, by definition, a refusal to enforce an arbitration agreement arises only in circumstances in which both parties to a contract have previously decided that inclusion of an arbitration provision is *mutually* beneficial. If auditors are unable to enforce arbitration agreements with insurance companies and, instead, are forced to resolve disputes through costly and time-consuming litigation, they will predictably charge higher fees when providing their services to insurance company clients or, in some cases, decline to serve such clients at all. As this Court has repeatedly observed, the costs and risks of litigation incurred by auditors and other professionals are ultimately passed on to their customers. See, *e.g.*, *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994) ("[E]xcessive litigation can have ripple effects. For example, newer and smaller companies may find it difficult to obtain advice * * * *[and] the increased costs incurred by professionals because of the litigation and settlement costs * * * may be passed on to their client companies."); *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*, 552 U.S. 148, 164 (2008) ("[C]ontracting parties might find it necessary to pro-

tect against these threats [of liability based on weak claims], raising the costs of doing business."). Empirical research has confirmed that observation. See, *e.g.*, Jamie Pratt & James Stice, *The Effect of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Fees*, 69 ACCT. REV. 639, 655 (1994); Frederick L. Jones & K. Raghunandan, *Client Risk and Recent Changes in the Market for Audit Services*, 17 J. ACCT. & PUB. POL'Y 169, 179 (1998).

Auditors can take scant comfort in the knowledge that the decision below, if uncorrected, would strip away their right to arbitrate "only" in disputes with insurance companies. Insurance is a $1.7 *trillion* industry in the United States, served by nearly 8000 insurers. See Nat'l Ass'n of Ins. Commissioners, *Overview of United States Insurance Market* (http://www.naic.org/state_report_cards/report_card_us.pdf). Nor is it any consolation that the decision would (at best) eliminate arbitration rights involving *financially troubled* insurance companies. The costs and risks of insurer claims against auditors (and the benefits of having those claims resolved expeditiously and efficiently, by a decision maker who truly understands the issues) are concentrated precisely in those insurance companies that have experienced financial difficulties, which the auditor may be unfairly expected to recompense.

The decision below does not just misconstrue the McCarran-Ferguson Act and conflict with prior decisions by this Court and others. It threatens real and serious harm to the auditing profession and the businesses, investors, and markets that depend on that profession.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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